A theoretical framework for understanding financial distortions: With special application to China

A Theoretical Framework for Understanding Financial Distortions: With Special Application to China

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Abstract: We attempt to explore the political roots of financially distorting policies ("FDP") by building a simple demand-supply framework in this study. On the demand side, in many countries, including non-democratic ones but particularly in democratic ones, interest groups are attracted by rents associated with FDP and therefore devote resources to distort financial policies to their advantage. On the supply side, governments, particularly governments in non-democratic regimes, are inclined to adopt FDP to channel financial resources to the key constituents of their regimes in exchange for their loyalty and support. The framework is shown to be useful in understanding financial situations in certain countries, such as China, where a highly distorted financial environment has been maintained for decades.

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I. Introduction

The relationship between financial development and economic growth has been of great interest for economists over the past three decades and has attracted numerous empirical studies that use country-level, industry-level, and firm-level data to explore this issue. The evidence as a whole tends to favor the argument that finance and financial regulation matter for, or even cause, economic growth.[1] In two survey papers, Levine concludes that the evidence "suggests a positive, first-order relationship between financial development and economic growth,"[2] and "taken as a whole, the bulk of existing research suggests that countries with better functioning banks and markets grow faster."[3] In a survey paper that uses meta-analysis methods, Valickova, Havranek, and Horvath also report that "the literature as a whole documents a moderate, but statistically significant, positive link between financial development and economic growth."[4] As a report issued by the World Bank

1 However, more recent studies challenge the conventional wisdom that finance unconditionally, linearly, and monotonically contributes to or even causes economic growth. *See generally* Jean Louis Arcand, Enrico Berkes & Ugo Panizza, *Too Much Finance?*, 20 J. ECON. GROWTH 105 (2015) (showing that the finance-growth nexus is now understood to be non-linear, non-monotonic, and context-dependent).

2 Ross Levine, *Financial Development and Economic Growth: Views and Agenda*, 35 J. ECON. LITERATURE 688, 688 (1997).

3 Ross Levine, *Finance and Growth: Theory and Evidence*, *in* HANDBOOK OF ECONOMIC GROWTH: VOL 1, PT. A 865, 868 (Philippe Aghion & Steven N. Durlauf eds., 2005).

4 Petra Valickova, Tomas Havranek & Roman Horvath, *Financial Development and Economic Growth: A Meta-Analysis*, 29 J. ECON. SURVS. 506, 522 (2015).

concludes, "finance is central to development."[5]

However, a financial system can hardly be expected to function effectively, and therefore contribute to economic growth, without certain institutional and legal underpinnings that can be relied upon to address certain weaknesses inherent in a financial system. On the micro level, financial institutions, such as banks, may use their informational advantages to exploit their clients and therefore lead to severe agency problems.[6] On the macro level, excessive financial development (such as credit growth exceeding real output growth) may lead to financial volatility or even crises, which in turn exerts a negative influence on output growth, as shown by Ductor and Grechyna[7] and Sahay et al.[8]

It is therefore necessary to create and maintain a legal and regulatory system to sustain financial development by, for example, improving information transparency, limiting moral hazard, and restricting excessive risk exposure. Indeed, the financial sector is among the most heavily regulated sectors of the economy around the world, and numerous policy tools and regulatory arrangements have been invented to correct market failures in the financial sector. Unfortunately, the real effects of these tools and arrangements are

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5 WORLD BANK, GLOBAL FINANCIAL DEVELOPMENT REPORT 2013: RETHINKING THE ROLE OF THE STATE IN FINANCE 17 (2012).

6 *See generally, e.g.*, Alexander Dyck, Adair Morse & Luigi Zingales, *How Pervasive is Corporate Fraud?*, 29–30 (Rotman School of Mgmt. Working Paper No. 2222608, 2013), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2222608 [https://perma.cc/L463-4EEF] (estimating that the cost of mostly financial fraud among U.S. companies with more than $750 million in revenues is $380 billion annually); Luigi Zingales, *Presidential Address: Does Finance Benefit Society?*, 70 J. FIN. 1327, 1347–48 (2015) (noting that, from January 2012 to December 2014, financial institutions paid United States enforcement fines totaling $138 billion, and lamenting, "I fear that in the financial sector fraud has become a feature and not a bug").

7 Lorenzo Ductor & Daryna Grechyna, *Financial Development, Real Sector, and Economic Growth*, 37 INT'L REV. ECON. & FIN. 393, 403 (2015) (noting that "[a]cceleration of financial development that is not accompanied by growth in the real sector reduces positive effect of financial development on growth; this effect might become negative if financial development grows substantially faster than real output").

8 Ratna Sahay et al., *Rethinking Financial Deepening: Stability and Growth in Emerging Markets*, IMF Staff Discussion Note SDN/15/08, at 30 (May 2015), https://www.imf.org/external/pubs/ft/sdn/2015/sdn1508.pdf [https://perma.cc/NBY5-72YV] (noting that "analysis uncovers evidence of 'too much finance' in recent years—that is, beyond a certain level of financial development the benefits to growth begin to decline and costs in terms of economic and financial volatility begin to rise").

debated.[9] Even worse, certain policy and regulatory tools are intentionally designed and implemented to intervene in the operation of financial markets, distort the allocation of financial resources, and prevent the financial intermediaries from functioning at their full capacity rather than strengthening and improving the functioning of financial markets.

We will refer to these tools as financially distorting policies ("FDP").[10] FDP include (but are not limited to) interest rate ceilings, capital account controls, restrictions on market entry into the financial sector, credit ceilings or restrictions on the direction of credit allocation, the government's ownership or control of banks, and the bailing out of failed institutions with public funds. The influence of FDP has been tested by numerous empirical studies, many of which have identified a negative association between FDP and certain economic variables, such as savings rates, investment, and economic growth.[11] Negative effects on economic growth have been demonstrated with respect to interest rate distortions,[12] but also

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9 *Compare* Puspa Delima Amri & Brett Matthew Kocher, *The Political Economy of Financial Sector Supervision and Banking Crises: A Cross-Country Analysis*, 18 EUR. L. J. 24 (2012) (highlighting the important role of financial regulation and supervision in reconciling the benefits of enhanced economic growth along with its costs), *with* JAMES R. BARTH, GERARD CAPRIO JR. & ROSS LEVINE, RETHINKING BANK REGULATION: TILL ANGELS GOVERN 12 (paperback ed. 2008) (concluding that "empowering direct official supervision of banks and strengthening capital standards do not boost bank development, improve bank efficiency, reduce corruption in lending, or lower banking system fragility").

10 The term "FDP" is basically interchangeable with, but slightly broader than, the term "financial repression," which can be traced back to the work of Ronald McKinnon's *Money and Capital in Economic Development* (1973) and Edward Shaw's *Financial Deepening in Economic Development* (1973). FDP is slightly broader in the sense that certain FDP, such as governments bailing out failed financial institutions, are not covered by the theory of financial repression but will be addressed under the umbrella of FDP. *See generally* Hiro Ito, *Financial Repression*, *in* 2 THE PRINCETON ENCYCLOPEDIA OF THE WORLD ECONOMY 430–33 (Kenneth Reinert & Ramkishen Rajan eds., 2008) (offering a description of the concept of financial repression); Guangdong Xu & Michael Faure, *Financial Repression in China: Short-term Growth but Long-term Crisis?*, 42 LOY. L.A. INT'L & COMP. L. REV. 1, 13 (2019) (providing more general discussions on financial repression).

11 For a general discussion on the role of FDP in economic development, see Konstantinos Loizos, *The Financial Repression-Liberalization Debate: Taking Stock, Looking for Synthesis*, 32 J. ECON. SURVS. 440 (2017) (reviewing the theoretical contributions and empirical studies of the financial repression-liberalization debate).

12 *See, e.g.*, Maxwell J. Fry, *Money and Capital or Financial Deepening in Economic Development*, 10 J. MONEY, CREDIT, & BANKING 464 (1978); Maxwell J. Fry, *In Favour of Financial Liberalisation*, 107 ECON. J. 754 (1997); Nouriel Roubini & Xavier Sala-i-

with respect to regulatory restrictions on bank competition.[13] Several studies have equally shown the negative effects of state ownership in the banking sector.[14] These studies have empirically shown the negative relationship between FDP and economic growth. However, another important dimension of FDP, i.e., the causes of FDP, particularly the political roots of FDP, seems to have attracted much less attention in the literature.[15] An important piece of the puzzle seems to be missing.

We attempt to fill this gap in this study. More specifically, we build a simple supply-demand framework to explore the political factors that may determine the existence and persistence of FDP. From the supply side, as the exclusive provider of public policies and economic regulations, the government (or the politicians who control the government) may distort financial markets so that valuable financial resources will be channeled to certain

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Martin, *Financial Repression and Economic Growth*, 39 J. DEV. ECON. 5, 29 (1992) (noting that their work had "confirmed . . . that financial repression affects growth negatively, inflation rates and growth rates are negatively related and reserve ratios and growth are negatively related").

13 *See generally, e.g.*, BARTH, CAPRIO & LEVINE, *supra* note 9 (presenting a new database on bank regulation in over 150 countries and offering a comprehensive cross-country assessment of the impact of bank regulation on the operation of banks); Allen N. Berger et al., *Bank Concentration and Competition: An Evolution in the Making*, 36 J. MONEY, CREDIT & BANKING 433 (2004) (reviewing the existing literature on the impact of bank concentration and competition).

14 *See, e.g.*, WORLD BANK, FINANCE FOR GROWTH: POLICY CHOICES IN A VOLATILE WORLD 131 (2001) (observing that data indicates "state banks . . . tend to decrease financial sector development and economic growth, to concentrate credit, and to increase the likelihood and cost of banking crises."); Rafael La Porta, Florencio Lopez-de-Silanes & Andrei Shleifer, *Government Ownership of Banks*, 57 J. FIN. 265, 267 (2002) (finding "that higher government ownership of banks is associated with slower subsequent development of the financial system, lower economic growth, and, in particular, lower growth of productivity").

15 Certain studies attempt to explain FDP by referring to the fiscal needs of governments. *See, e.g.*, Chong-En Bai et al., *Financial Repression and Optimal Taxation*, 70 ECON. LETTERS 245 (2001); Alberto Giovannini & Martha de Melo, *Government Revenue from Financial Repression*, 83 AM. ECON. REV. 953 (1993); Yothin Jinjarak, *Economic Integration and Government Revenue from Financial Repression*, 37 ECON. SYS. 271 (2013); Victor Menaldo, *The Fiscal Roots of Financial Underdevelopment*, 60 AM. J. POL. SCI. 456, 456 (2016) (arguing that "the state might . . . have its own fiscal reasons for politicizing the supply and price of credit, since financial repression provides easy-to-collect revenues . . . . the state's fiscal imperative is usually the primary reason behind financial repression, and even when private actors benefit, they are subordinate to this concern" and that "strong empirical support [exists] for [his] fiscal transaction cost theory").

constituents whose support is critical for the survival of the government (or the controlling politicians). From the demand side, the administration, legislature, and regulatory agencies may be captured by powerful elites and interest groups; as a result, financial policies and regulations and their enforcement will be distorted to benefit these elites and interest groups at the cost of economic efficiency and social welfare. These two mechanisms may function separately or jointly; either way, the financial policies are distorted. Our theoretical framework allows us to understand why in different legal systems, including the United States, governments often adopt financially distorting policies. But we will show that the theoretical framework we develop is equally applicable to explain the emergence of FDP in new economies such as China. Our study therefore contributes to the literature by showing that the political economy context is essential for understanding the performance of a financial system.

The remainder of the paper is organized as follows. In section II, we offer a demand side analysis by discussing the role of interest groups in shaping FDP. The influence of supply side, i.e., the connection between the nature of regimes and financial distortions, will be addressed in section III. The results of the demand and supply-side analyses will be combined by summarizing the shape of the market for FDP in section IV. And in section V, China will be used as a case illustration for the theoretical framework presented in this study. Finally, we conclude in section VI.

II. The Demand for Financially Distorting Regulation

We start by explaining the emergence of financially distorting regulation by focusing on the demand for regulation. In part A, we explain that FDP create rents which may benefit interest groups, which is precisely the reason why they will devote substantial resources to lobby the creation of FDP. Part B demonstrates that the result is that interest groups, more particularly banks and other financial institutions, are quite successful in creating policies that are beneficial to them, and they are also influential in policy implementation. Part C discusses interest groups, as beneficiaries of FDP have different advantages which may explain their success. Finally, Part D examines why reforming or abolishing FDP therefore becomes extremely difficult.

A. *Interest Groups and Rent-Seeking*

The key to understanding the existence and persistence of FDP is that once FDP are in place, tremendous economic rents[16] will be generated. In the literature of political economy, economic rents usually refer to the abnormal profits earned by politically favored entities with the help of certain governmental policies, such as licenses, tariffs, and other regulatory arrangements.[17] The meaning of economic rents in the context of the financial sector may be illustrated in Figure 1, which shows the impact of interest rate ceilings, one of the most commonly used strategies of FDP. With an interest rate ceiling set at r_0, which is below the market-clearing equilibrium rate, r_E, the demand for loanable funds, L_2, greatly exceeds the available supply, L_1. This excess demand calls for the rationing of the limited supply, and more importantly, those who have access to the rationed credit are entitled to the rents that arise from the difference between the low, regulated loan rate and the market-clearing rate.

Certainly, rents can be created by other policy distortions. For example, incumbent banks may enjoy rents if entry into the banking industry is highly restricted, listed firms may enjoy rents if the procedure of initial public offering is extremely inconvenient, and certain export industries and enterprises may enjoy rents if the currency is artificially depreciated. The magnitude of rents can be tremendous. For example, Huang reports that in China, financial rents (in the form of artificially low interest rates of bank loans) received by the Chinese enterprise sector amounted to CNY 607 billion, or 2 percent of its GDP, in 2008.[18] Similarly, Reinhart and Sbrancia report that for advanced economies, real interest rates were

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16 An economic rent, according to Tollison, "is a payment to a resource owner above the amount his resources could command in their next best alternative use . . . . [Put otherwise, it] is a receipt in excess of the opportunity cost of a resource." Robert D. Tollison, *Rent Seeking: A Survey*, 35 KYKLOS 575, 577 (1982).

17 *See* GERRIT DE GEEST, RENTS: HOW MARKETING CAUSES INEQUALITY (2018) (providing further discussion on rents).

18 *See* Yiping Huang, *China's Great Ascendancy and Structural Risks: Consequences of Asymmetric Market Liberalization*, 24 ASIAN-PAC. ECON. LIT. 65, 78 (2010). Yiping Huang & Kunyu Tao confirmed this phenomenon over an extended period, measuring rents as they varied with policy distortions from 2000 to 2008 and finding that financial rents were highest in 2000, when they were the equivalent of 4.1% of GDP; Yiping Huang & Kunyu Tao, *Factor Market Distortion and the Current Account Surplus in China*, 9 ASIAN ECON. PAPERS 1, 22–23, 26 (2010).

negative in about half of the years during the 1945-1980 period; as a result of this repression policy, the average annual interest expense savings for their twelve-country sample ranged from 1% to 5% of its GDP.[19]

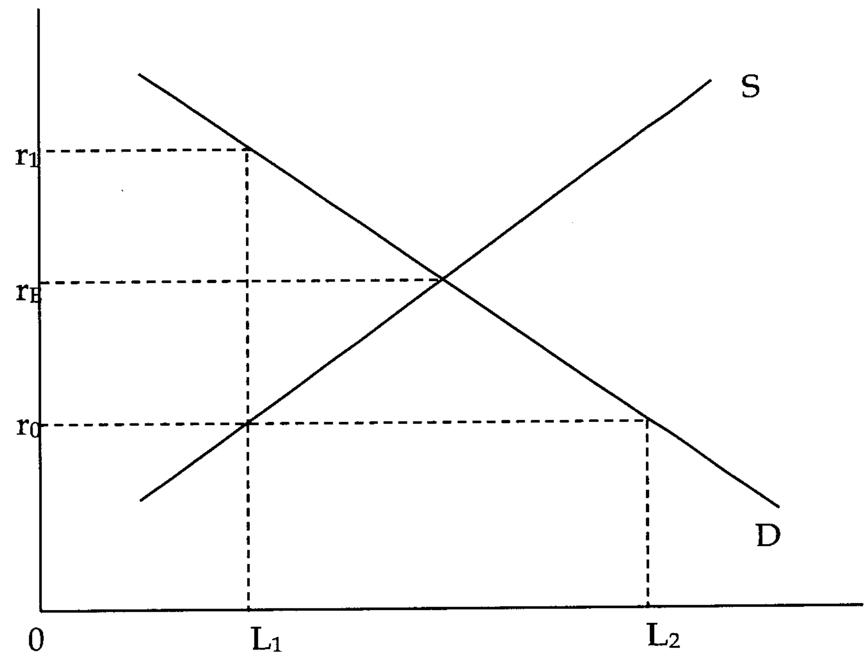

Figure 1. The Effects of Interest-Rate Ceilings on Loanable Funds

As the literature of rent-seeking has shown, rents will attract rent-seeking efforts by certain interest groups,[20] which will in turn translate into politically favorable arrangements through which economic rents can be effectively entrenched.[21] Generally

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19 *See* Carmen M. Reinhart & M. Belen Sbrancia, *The Liquidation of Government Debt*, 30 ECON. POL'Y 291, 291 (2015).

20 In certain extreme cases, rent-seeking expenditures may even overweigh the rents and therefore lead to a complete dissipation of rents. *See* Toke S. Aidt, *Rent Seeking and the Economics of Corruption*, 27 CONST. POL. ECON. 142, 152 (2016); Ignacio Del Rosal, *The Empirical Measurement of Rent-Seeking Costs*, 25 J. ECON. SURVS. 298, 299 (2011).

21 Certain studies show that lobbying expenditures by interest groups effectively influence trade policies (their levels of trade protection). *See* Jeffrey M. Drope & Wendy L. Hansen, *Purchasing Protection? The Effect of Political Spending on U.S. Trade Policy*, 57 POL. RES. Q. 27 (2004); Patricia Tovar, *Lobbying Costs and Trade Policy*, 83 J. INT. ECON. 126, 126–36 (2011). Amy McKay further reports "finding surprisingly little relationship between organizations' financial resources and their policy success - but

speaking, policies and regulations can be distorted by rent-seekers through two means:[22] (1) rent-seekers may fundamentally change the rules of the game by manipulating the legislative process through which certain distorting policies, laws, and regulations will be issued; or (2) rent-seekers may bypass the legislative process and leave the current (efficient) policies and laws intact but turn to sabotaging their enforcement by corrupting regulatory agencies who are responsible for enforcing these policies and laws. Either way, resource allocation is distorted, and economic efficiency is sacrificed.

Numerous studies have shown that different interest groups use different rent-seeking strategies in different economic and political environments. For example, using data for approximately 4,000 firms in 25 transition countries, Campos and Giovannoni find that it is more likely for a firm to join a lobbying group (rule-changing activity) if the firm is large, foreign-owned, and located in a country that is more economically developed and more politically stable.[23] Campos and Giovannoni further show that lobbying and corruption (enforcement-sabotaging activity) are substitutes (a significantly negative connection between lobbying and corruption is identified).[24] Similarly, Harstad and Svensson build a model showing that on the micro level, large firms tend to lobby and small firms tend to bribe (enforcement-sabotaging), and on the macro level, firms lobby in rich countries but bribe in poor countries.[25] Naoi and Krauss further show that the organizational structure of interest groups, in particular, whether they are centralized or decentralized, substantially affects their lobbying strategies

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greater money is linked to certain lobbying tactics and traits, and some of these are linked to greater policy success." Amy McKay, *Buying Policy? The Effects of Lobbyists' Resources on Their Policy Success*, 65 POL. RES. Q. 908, 908 (2012).

22 Certainly, there are other channels through which interest groups may influence the process of financial development, such as resorting to the judiciary. *See* Thomas T. Holyoke, *Choosing Battlegrounds: Interest Group Lobbying Across Multiple Venues*, 56 POL. RES. Q. 325, 325 (2003) (creating a model and testing it "with data from interviews with lobbyists for groups that were active on the issue of financial modernization between 1997 and 1999").

23 *See* Nauro F. Campos & Francesco Giovannoni, *Lobbying, Corruption and Political Influence*, 131 PUB. CHOICE 1, 20 (2007).

24 *Id.* at 17.

25 *See* Bård Harstad & Jakob Svensson, *Bribes, Lobbying, and Development*, 105 AM. POL. SCI. REV. 46, 56–57 (2011).

(targeting politicians or bureaucrats).[26]

B. Evidence of Successful Rent-Seeking

The beneficiaries of FDP, such as financial institutions, are indeed highly involved in the political process in terms of political contributions and lobbying expenditure. For example, McCarty, Poole, and Rosenthal report that in the United States, the campaign contribution from the financial sector increased almost threefold between 1992 and 2008, and the magnitude of contribution from the financial industry to political campaigns is the highest among all industries.[27] Such spending is indeed rewarding. Evidence shows that thanks to its lobbying expenditures and campaign contributions, the financial industry enjoyed favorable policies before the financial crisis of 2008 and received generous bailouts during the financial crisis. Igan and Mishra report that in the United States, from 1999 to 2006, spending on lobbying by the financial industry was positively associated with the probability of a legislator changing positions in favor of deregulation.[28] Mian, Sufi and Trebbi find that there is a positive relation between the amount of financial service industry campaign contributions received by a politician and the probability of his (or her) voting for the Emergency Economic Stabilization Act[29] (also known as the Troubled Asset Relief Program, "TARP"), which was enacted in October 2008 and enables the Treasury Department to recapitalize banks through direct purchase of new equity and severely distressed mortgage backed securities up to $700 billion.[30] The connection between campaign contributions and legislative voting for TARP is further confirmed by other studies.[31]

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26 *See* Megumi Naoi & Ellis Krauss, *Who Lobbies Whom? Special Interest Politics under Alternative Electoral Systems*, 53 AM. J. POL. SCI. 874, 889 (2009).

27 *See* NOLAN MCCARTY, KEITH T. POOLE & HOWARD ROSENTHAL, POLITICAL BUBBLES: FINANCIAL CRISES AND THE FAILURE OF AMERICAN DEMOCRACY 117–48 (Princeton Univ. Press ed., 2013).

28 Deniz Igan & Prachi Mishra, *Wall Street, Capitol Hill, and K Street: Political Influence and Financial Regulation*, 57 J. L. & ECON. 1063, 1063 (2014).

29 *See* Atif Mian, Amir Sufi & Francesco Trebbi, *The Political Economy of the US Mortgage Default Crisis*, 100 AM. ECON. REV. 1967, 1988 (2010).

30 *Id.* at 1968.

31 *See generally, e.g.*, Jim F. Couch et al., *An Analysis of the Financial Services Bailout Vote*, 31 CATO J. 119 (2011) (constructing a model to analyze the bailout vote of each legislator); Michael Dorsch, *Bailout for Sale? The Vote to Save Wall Street*, 155 PUB.

In addition to political contributions and lobbying expenditure, there are other channels through which policies may be influenced. Duchin and Sosyura show that in addition to campaign contributions and lobbying expenditure, other political connections, such as employing a director who worked at the Treasury or one of the banking regulators, or headquartered in the election districts of House members on key financial committees, also help a financial firm to access the federal rescue funds from the TARP.[32] Blau, Brough, and Thomas report that financial firms that lobbied during the five years prior to the TARP (or have other political connections) are not only more likely to receive TARP funds but also to receive a greater amount of TARP support and to receive the support earlier than firms that are not politically involved.[33]

Certainly, interest groups shape financial policies not only in the United States and not only at present. Historically, studies report that interest groups in the United States influenced the intensity of a variety of regulations. Benmelech and Moskowitz, for example showed the influence of interest groups on the severity of state usury laws in the 19th century.[34] They report that state suffrage laws that restrict who can vote based on land ownership and tax payments (not race or gender) keep political power in the hands of wealthy incumbents, and that such wealth-based voting restrictions are highly correlated with financial restrictions (tighter usury laws).[35] Also, the development of the banking sector in the early 20th century was influenced by interest groups.[36] Counties in the United

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CHOICE 211 (2013) (noting studies that confirm the connection between campaign contributions and legislative voting for TARP).

32 *See* Ran Duchin & Denis Sosyura, *The Politics of Government Investment*, 106 J. FIN. ECON. 24, 26 (2012).

33 Benjamin M. Blau, Tyler J. Brough & Diana W. Thomas, *Corporate Lobbying, Political Connections, and the Bailout of Banks*, 37 J. BANKING & FIN. 3007, 3007 (2013).

34 *See* Efraim Benmelech & Tobias J. Moskowitz, *The Political Economy of Financial Regulation: Evidence from U.S. State Usury Laws in the 19th Century*, 65 J. FIN. 1029, 1070–71 (2010).

35 *See id.* at 1070–71 (noting, among other things, that "[o]ur evidence suggests that incumbents with political power prefer stringent usury laws because they impede competition from potential new entrants who are credit rationed . . . [;] that financial regulation is correlated with other restrictive political and economic policies adopted by the state designed to exclude other groups and protect incumbent interests . . . [; and, that] [t]he collection of evidence supports the private interest view of financial regulation and highlights the political economy of financial development").

36 *See generally* Raghuram G. Rajan & Rodney Ramcharan, *Land and Credit: A*

States where the agricultural elite had disproportionately large land holdings had significantly fewer banks per capita; in addition, credit appears to have been more costly, and access to it more limited, in these counties.[37] The reason is that large landowners may restrict financial development in order to limit access to finance, so that they may extract more rents from tenants and small farmers.[38] The timing of branching deregulation in the banking sector in the last quarter of the 20th century was also related to the influence of interest groups.[39] Interest group factors related to the relative strength of potential winners (large banks and small, bank-dependent firms) and losers (small banks and the rival insurance firms) can explain the timing of branching deregulation across the states.[40]

The process of financial development in the United States is therefore argued to be shaped by political battles between the winners and losers of financial development.[41] Witko argues that the interests of low-income individuals and the working class are harmed by the process of financial development, whereas the firms in the financial industry appear to be the major beneficiary. Between 1949 and 2005, the struggles between the organizations and parties representing the losers versus those representing the winners shaped the financial landscape of the United States to a large extent. Thus, "when groups representing the losers of financialization are less powerful, this process advances more rapidly . . . when the financial industry is more active in politics, financialization proceeds more rapidly."[42]

From a comparative perspective, Rajan and Zingales examine the financial development of twenty-four countries during the 20th century and find that the state of development in the financial sector

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Study of the Political Economy of Banking in the United States in the Early 20th Century, 66 J. FIN. 1895 (2011) (describing how large landholders restricted the development of banking and finance in early 20th century America).

37 *Id.* at 1895.

38 *Id.* at 1896–97.

39 Randall S. Kroszner & Philip E. Strahan, *What Drives Deregulation? Economics and Politics of the Relaxation of Bank Branching Restrictions*, 114 Q. J. ECON. 1437, 1437 (1999).

40 *Id.*

41 *See* Christopher Witko, *The Politics of Financialization in the United States, 1946-2005*, 46 BRIT. J. POL. SCI. 349, 364 (2014).

42 *Id.* at 349.

does not change monotonically over time.[43] They therefore apply interest group theory to explain the rise and fall of financial markets in these countries. They argue that incumbents, both in the financial sector and in industry, have a vested interest in preventing financial development because a more efficient financial system facilitates entry and encourages competition, which leads to lower profits for incumbent firms and financial institutions. However, when a country's borders are open to both trade and capital flows, the incentives and abilities of incumbents to oppose financial development are muted and financial development will flourish.[44] This theory, by Rajan and Zingales, concerning the relationship between the influence of interest groups and the rise and fall of financial markets has been further tested and confirmed by other studies.[45]

Interest groups may not only influence policy design but also policy implementation. For example, Heinemann and Schüler find that there is a negative connection between the size of the banking industry and the strength of the regulatory regime, implying that banks may use their influence to alleviate regulatory stringency.[46] One explanation for the relative success of interest groups relates to the phenomenon of the "revolving door" between financial institutions and their regulators. The term "revolving door" refers to "the movement of individuals back and forth between public office and private companies, in order to exploit their period of service to the benefit of their current employer."[47] The "revolving

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43 Raghuram G. Rajan & Luigi Zingales, *The Great Reversals: The Politics of Financial Development in the 20th Century*, 69 J. FIN. ECON. 5, 5, 14–17 (2003).

44 *Id.* at 7, 17–19.

45 *See, e.g.*, Matias Braun & Claudio E. Raddatz, *The Politics of Financial Development: Evidence from Trade Liberalization*, 63 J. FIN. 1469 (2008) (finding the "benefits of developing the financial system are insufficient for financial development, and rents in particular hands appear to be necessary to achieve it."); David Hauner, Alessandro Prati & Cagatay Bircan, *The Interest Group Theory of Financial Development: Evidence from Regulation*, 37 J. BANKING & FIN. 895, 895 (2013) (noting that "[i]n line with the theory [of interest group financial development put forward by Rajan and Zingales in 2003], we find strong evidence that trade liberalization is a leading indicator of domestic financial liberalization . . . . [but], in contrast to the theory, we do not find consistent evidence of an effect of capital account liberalization").

46 Friedrich Heinemann & Martin Schüler, *A Stiglerian View on Banking Supervision*, 121 PUB. CHOICE 99, 121 (2004).

47 *Transparency International, Regulating the Revolving Door* 2 (Working Paper No. 06/2010) (2010).

door" can move in two directions. The first direction is from the government to the private sector, i.e., public officials (elected or appointed) and civil servants move to lucrative private sector positions, where they may use their government experience and connections to unfairly benefit their new employer.[48] The second direction is from the private sector to the government, such as appointing corporate executives to key public offices and posts in government, which may raise the possibility of a pro-business bias in policy formulation and regulatory enforcement.[49] The result of this interest group influence is the well-known problem of "regulatory capture."[50] Regulatory capture is "the result or process by which regulation, in law or application, is consistently or repeatedly directed away from the public interest and toward the interests of the regulated industry, by the intent and action of the industry itself."[51] In the context of the financial sector, regulatory capture is described as a situation "in which bankers enjoy large rents, in return for which they were willing to finance government expenditures, within certain constraints, and to do other favors for government officials."[52]

The result of regulatory capture, and the corresponding influence of interest groups on financial regulation is precisely the financial distortion central to this article. Many studies have shown

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48 *See* Ernesto Dal Bó, *Regulatory Capture: A Review*, 22 OXFORD REV. ECON. POL'Y 203, 214 (2006).

49 *See id.*

50 The theory of regulatory capture can be traced back to the early work of Nobel Prize Winner George Stigler, as well as the work of Sam Peltzman. George J. Stigler, *The Theory of Economic Regulation*, 2 BELL J. ECON. & MGMT. SCI. 3 (1971); Sam Peltzman, *Toward a More General Theory of Regulation*, 19 J. L. & ECON. 211 (1976). However, nowadays, the value of this theory to fully explain incentives and the behavior of regulatory agencies is debated. For a critical account, see DANIEL CARPENTER & DAVID A. MOSS, PREVENTING REGULATORY CAPTURE: SPECIAL INTEREST INFLUENCE AND HOW TO LIMIT IT (2014).

51 *Introduction*, *in* PREVENTING REGULATORY CAPTURE: SPECIAL INTEREST INFLUENCE AND HOW TO LIMIT IT 13 (Daniel Carpenter & David A. Moss eds., 2014). In the literature, both broad and narrow interpretations of regulatory capture are presented. The broad interpretation defines regulatory capture as "the process through which special interests affect state intervention in any of its forms, which can include areas as diverse as the setting of taxes, the choice of foreign or monetary policy, or the legislation affecting R&D," whereas the narrow interpretation describes regulatory capture as "the process through which regulated monopolies end up manipulating the state agencies that are supposed to control them." *See* Dal Bó, *supra* note 48, at 203.

52 BARTH, CAPRIO & LEVINE, *supra* note 9, at 35.

how interest groups' influence in the financial sector leads to pervert financial regulation and the corresponding distortions. For example, Baxter argues that "examples of recent strong industry bias on the part of key financial regulators seem to abound. There is ample evidence from various regulatory actions that the industry, particularly large financial organizations, have enjoyed surprising favor at the hands of the financial regulators."[53] Related to the financial crisis, it was even argued that "in large part, the latest crisis [the financial crisis of 2008] was also attributable to the regulators' failure to maintain their independence from the financial industry and to act in a truly public minded manner—the phenomena commonly associated with the concept of regulatory capture."[54] Gadinis further shows that since the financial crisis of 2008, concerns about regulatory capture have led to a paradigm shift in fifteen OECD countries in which more regulatory powers are allocated to politically controlled officials, such as treasury secretaries and finance ministers, rather than to independent agencies.[55] Levitin undertook a literature review examining six books dealing with the financial crisis of 2008.[56] As a result of this study, he argues that regulatory capture should be blamed for enabling the financial crisis.[57] However, some empirical studies provide a more balanced picture.[58] Those studies argue that the available empirical evidence is inconsistent with the "regulatory capture" hypothesis, but consistent with a "regulatory schooling" hypothesis (i.e., workers in the private sector may move into the regulatory sector to get schooled in the new complexity and then move from regulation to the private sector to earn the returns from

53 Lawrence G. Baxter, *'Capture' in Financial Regulation: Can We Channel It Toward the Common Good?*, 21 CORNELL J. L. & PUB. POL'Y 175, 181 (2011).

54 Saule T. Omarova, *Bankers, Bureaucrats, and Guardians: Toward Tripartism in Financial Services Regulation*, 37 J. CORP. L. 621, 629 (2012).

55 Stavros Gadinis, *From Independence to Politics in Financial Regulation*, 101 CALIF. L. REV. 327, 332 (2013).

56 Adam J. Levitin, *The Politics of Financial Regulation and the Regulation of Financial Politics: A Review Essay*, 127 HARV. L. REV. 1991, 1992 (2014).

57 *See id.* at 2068.

58 *See, e.g.*, David Lucca, Amit Seru & Francesco Trebbi, *The Revolving Door and Worker Flows in Banking Regulation*, 65 J. MONETARY ECON. 17 (2014); Sophie A. Shive & Margaret M. Forster, *The Revolving Door for Financial Regulators*, 21 REV. FIN. 1445 (2017).

regulatory schooling).[59]

C. *Advantages Enjoyed by Interest Groups*

In part A (above), we showed that interest groups in the financial sector have incentives to develop rent-seeking activities and will devote substantial efforts to rent-seeking. Moreover, in Part B, we showed that interest groups usually will prevail in the political battlefield because they have the will and resources to influence political and regulatory processes. However, the success of the interest groups leading to financially distorting regulation is equally due to specific structural advantages of the interest groups in the financial sector which may facilitate the rent-seeking process. Important is the fact that (1) interest groups in the financial sector have relatively easy ways of getting organized, (2) that the financially distorting regulations they seek are often justified by referring to the negative outcomes of financial liberalization, and (3) that financially distorting policies are usually the result of mixed strategies.

1. *Low Costs in Organization*

First, it may be argued that the beneficiaries of FDP may organize themselves more easily and more effectively and therefore exert more influence on legislators and bureaucrats than their rivals, the victims of financial distortions. Usually the beneficiaries of FDP are small groups, such as banks and certain industries or enterprises, whereas the victims are large groups, such as depositors and minority shareholders. For example, as a result of interest rate controls, depositors (particularly household sector) will be hurt because their interest earnings will be less than they would have been in a liberal financial environment, whereas enterprises will benefit from such a repressive policy as the cost of credit is artificially lowered.[60]

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59 *Id.*

60 Certainly, not all enterprises can benefit from such a policy because interest rate controls are usually accompanied by credit rationing, which means that certain enterprises may be crowded out of the formal credit markets. Similarly, other financial regulations may benefit certain enterprises at the cost of other enterprises (such as currency devaluation, which may benefit export enterprises but hurt import enterprises); or certain policies that benefit certain financial institutions at the cost of other financial institutions like the role of Regulation Q in the process of financial development in the United States. *See* R. Alton Gilbert, *Requiem for Regulation Q: What It Did and Why It Passed Away*,

As Olson argued decades ago, because the collective action problem inherent in pursuing common objectives is more severe for large groups than for small groups, "small groups will further their common interests better than large groups."[61] The empirical evidence confirms Olson's conclusion by showing that even in the United States, a country that has a highly developed democracy and a well-functioning checks-and-balance system, small groups, particularly economic elites and business interests, rather than the interests of the general public, dominate the policy-making process.[62] Business and trade associations make up more than half of the Washington lobbying community, accounting for 65% of the registrations, 69% of the reports filed, and 70% of the issues mentioned, and spending over nine times more money on lobbying than citizen groups and nonprofits.[63] It was also found that business interests participate in the "notice and comment" procedures (through which federal agencies can solicit and take into account the views of concerned citizens prior to the promulgation of most final agency rules) more vigorously and therefore are able to shift agency rules toward their desired level of government regulation.[64] In a 2014 study, Gilens and Page show that both individual economic elites (proxied by Americans at the ninetieth income percentile) and powerful interest groups (including those groups that appear over the years in Fortune magazine's "Power 25" lists and ten key industries that have reported the highest lobbying expenditure) play a substantial part in affecting public policy, whereas the general public (proxied by citizens at the fiftieth income percentile) has little or no independent influence.[65] It is therefore not surprising to find that financial policies are considerably responsive to the pressure from powerful interest groups, such as

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FED. RES. BANK OF ST. LOUIS REV. 22 (1986); *see also* FREDERIC S. MISHKIN, THE ECONOMICS OF MONEY, BANKING, AND FINANCIAL MARKETS (7th ed. 2004).

61 MANCUR OLSON, THE LOGIC OF COLLECTIVE ACTION: PUBLIC GOODS AND THE THEORY OF GROUPS 52 (1965).

62 *Id.*

63 Frank R. Baumgartner & Beth L. Leech, *Interest Niches and Policy Bandwagons: Patterns of Interest Group Involvement in National Politics*, 63 J. POL. 1191, 1196–97 (2001).

64 Jason Webb Yackee & Susan Webb Yackee, *A Bias Toward Business? Assessing Interest Group Influence on the U.S Bureaucracy*, 68 J. POL. 128, 128–130 (2006).

65 Martin Gilens & Benjamin I. Page, *Testing Theories of American Politics: Elites, Interest Groups, and Average Citizens*, 12 PERSP. ON POL. 564, 565 (2014).

banks.[66]

2. *Financial Liberalization*

Second, it is easy to justify certain financial regulations that may lead to distortions, given the seemingly close connection between financial liberalization and economic crisis. Financial liberalization has been characterized as "the process of giving the market the authority to determine who gets and grants credit and at what price," and full liberalization involves

> the government's also allowing entry into the financial-services industry to any company that can satisfy objectively specified criteria based on prudential considerations (concerning capital, skills, and reputation), giving banks the autonomy to run their own affairs, withdrawal from the ownership of financial institutions, and abandoning control over international capital movements.[67]

This characterization suggests six dimensions of financial liberalization: (1) the elimination of credit controls; (2) the deregulation of interest rates; (3) free entry into the banking sector or, more generally, the financial-services industry; (4) bank autonomy; (5) private ownership of banks; and (6) the liberalization of international capital flows.[68] In general, financial liberalization means a process of partially or wholly removing FDP.[69]

Unfortunately, financial liberalization may lead to both financial development and financial crisis. Kaminsky and Reinhart examined the relationship between banking crises and financial liberalization.[70] They report that in eighteen of the twenty-six

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66 Charles L. Weise, *Private Sector Influences on Monetary Policy in the United States*, 40 J. MONEY, CREDIT & BANKING 449 (2008) (examining "the extent to which the Federal Reserve's monetary policy actions are correlated with the expressed wishes of private sector lobbying groups"); Avi Ben-Bassat, *Conflicts, Interest Groups, and Politics in Structural Reforms*, 54 J. L. & ECON. 937 (2011) (finding "the greater extent of conflicts among regulations and the greater the intensity of the opposition of interest groups, the lower the probability that a reform will be approved").

67 *See* John Williamson & Molly Mahar, *A Survey of Financial Liberalization*, 211 ESSAYS IN INT'L FIN. 1, 2 (1998).

68 *Id.*

69 *Id.* at 11–31.

70 *See* Graciela L. Kaminsky & Carmen M. Reinhart, *The Twin Crises: The Causes of Banking and Balance-of-Payments Problems*, 89 AM. ECON. REV. 473 (1999).

banking crises that they studied, the financial sector had been liberalized during the preceding five years.[71] A similar association between financial liberalization and financial crisis is further confirmed in other studies as well.[72] However, recent studies find that the relationship between financial liberalization and financial crisis is more complicated.[73]

Although the empirical evidence concerning the relationship between financial liberalization and economic crisis is therefore mixed, beneficiaries of FDP may use a selection of the studies to defend their positions. More particularly, they could argue that serious financial crises could be avoided by certain distorted financial policies, although economic efficiency may be sacrificed. In other words, interest groups may argue that financial liberalization should be avoided to prevent financial crises even though, as mentioned, the empirical evidence that financial liberalization would cause economic crisis is weak at best. For example, this could lead to pleas for the creation of entry barriers, notwithstanding their efficiency-damaging effects.[74] Barriers to market entry would help, so the interest groups would argue, to stabilize the financial sector. They can receive some support from studies showing that competition in financial markets may increase

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71 *Id.* at 474.

72 *See* Williamson & Mahar, *supra* note 67; Asli Demirguc-Kunt & Enrica Detragiache, *Financial Liberalization and Financial Fragility* (IMF Working Paper, WP/98/83 1998); Asli Demirguc-Kunt & Enrica Detragiache, *The Determinants of Banking Crises in Developing and Developed Countries*, 45(1) IMF STAFF PAPERS 81–109 (1998); Aaron Tornell, Frank Westermann & Lorenza Martinez, *Liberalization, Growth, and Financial Crises: Lessons from Mexico and the Developing World*, 34 BROOKINGS PAPERS ON ECONOMIC ACTIVITY 1 (2003).

73 Romain Rancière, Aaron Tornell & Frank Westermann, *Decomposing the Effects of Financial Liberalization: Crises vs. Growth*, 30 J. BANKING & FIN. 3331 (2006); Graciela L. Kaminsky & Sergio L. Schmukler, *Short-Run Pain, Long-Run Gain: Financial Liberalization and Stock Market Cycles*, 12 REV. FIN. 253 (2008); Apanard Angkinand, Wanvimol Sawangngoenyuang & Clas Wihlborg, *Financial Liberalization and Banking Crises: A Cross-Country Analysis*, 10 INT'L REV. FIN. 263 (2010); Christopher A. Hartwell, *If You're Going Through Hell, Keep Going: Nonlinear Effects of Financial Liberalization in Transition Economies*, 53 EMERGING MARKETS FIN. & TRADE 250 (2017); Helmi Hamdi & Nabila Boukef Jlassi, *Financial Liberalization, Disaggregated Capital Flows and Banking Crisis: Evidence from Developing Countries*, 41 ECON. MODELLING 124 (2014); Choudhry Tanveer Shehzad & Jakob De Haan, *Financial Reform and Banking Crises* (CESifo Working Paper, No. 2870 2009).

74 *See* BARTH, CAPRIO & LEVINE, *supra* note 9; Berger et al., *supra* note 13, at 439, 445.

the moral hazard problem of banks by eroding bank profits, which in turn undermines bank franchise values (the capitalized value of expected future profits) and induces banks to gamble on more risky projects.[75] These types of arguments would therefore be used by interest groups to restrict competition via the creation of entry barriers which de facto only lead to further financial distortions.

3. *Mixes of Distortions*

Third, one distortion may be intertwined with another, and the package of FDP is therefore hard to be reformed in a piecemeal manner. For example, Prasad shows that China's interest rate policy has been severely weakened by the undervalued currency strategy.[76] More specifically, as a result of China's undervaluation of its currency, the volume of export continually increases, capital inflows steadily grow, and a dramatic accumulation of foreign exchange reserves has been observed.[77] In general, whereas undervaluation may promote economic growth in the short or medium term, maintaining this policy for too long will have significant adverse consequences, such as an excessive accumulation of low-yielding foreign reserves and high and destabilizing liquidity growth and inflation.[78] To sterilize the liquidity generated by this growth pattern (and to address the corresponding inflation problem), the central bank has to set interest rates administratively at very low levels so that its sterilization costs can be minimized and the speculative capital inflows can be discouraged.[79] Distorted interest rates will in turn lead to other inefficiencies, such as credit discrimination and the rise of a shadow banking system.[80] The dilemma is that reforming the whole package of FDP may be politically difficult and technically complicated, but only focusing on one dimension of FDP and leaving other

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75 Thomas F. Hellmann, Kevin C. Murdock & Joseph E. Stiglitz, *Liberalization, Moral Hazard in Banking, and Prudential Regulation: Are Capital Requirements Enough?*, 90 AM. ECON. REV. 147 (2000).

76 Eswar S. Prasad, *Is the Chinese Growth Miracle Built to Last?*, 20 CHINA ECON. REV. 103, 110–14 (2009).

77 *Id.* at 104, 114.

78 Mona Haddad & Cosimo Pancaro, *Can Real Exchange Rate Undervaluation Boost Exports and Growth in Developing Countries? Yes, But Not for Long*, 20 ECON. PREMISE 1, 2 (2010).

79 Prasad, *supra* note 76, at 112–15.

80 *Id.* at 114.

dimensions intact may not bring about significant efficiency improvements.

D. Summary

In summary, interest groups may be attracted by rents associated with FDP and therefore devote resources to influence both policy design (by colluding with politicians) and policy implementation (by corrupting regulators) so that FDP will be adopted and maintained. FDP benefits special interest groups at the cost of economic efficiency and social welfare; however, reforming or abolishing FDP turns out to be difficult because interest groups usually enjoy organizational advantages, financial liberalization is risky, and financial distortion may be intertwined with one another.

III. The Supply of Financially Distorting Regulation

What we have just discussed, i.e., the role of interest groups in shaping FDP, is only a part of the story. On the "market" of financial laws and regulations, interest groups act like consumers, whose demands certainly influence the production of certain institutional products, such as legislations, judgments, and regulatory sanctions. However, these institutional products will not emerge just because they are demanded. Rather, they need to be supplied. We therefore need to examine the role of another important player in the political arena, the government, which is supposed to be the exclusive supplier of law and order in the modern world.[81] Why would politicians supply financially distorting regulations?

We first argue that whereas private actors are rent-seeking, politicians are engaged in rent-extraction (A); the extent to which

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81 However, it is worth noting that, worldwide, properly functioning governments that supply public goods such as law and order are the exception, not the rule. Peter T. Leeson, *Better Off Stateless: Somalia Before and After Government Collapse*, 35 J. COMP. ECON. 689, 691, 705 (2007); Peter T. Leeson & Claudia R. Williamson, *Anarchy and Development: An Application of the Theory of Second Best*, 2 L. & DEV. REV. 76 (2009). Even in developed countries with well-functioning governments, private supply of law and order is not uncommon. ROBERT C. ELLICKSON, ORDER WITHOUT LAW: HOW NEIGHBORS SETTLE DISPUTES (1991). In some extreme cases in which the government does not enforce laws effectively, individuals will seek out an alternative order maintainer, such as organized crime in Japan and Sicily. Curtis J. Milhaupt & Mark D. West, *The Dark Side of Private Ordering: An Institutional and Empirical Analysis of Organized Crime*, 67 UNIV. CHI. L. REV. 41, 41 (2000); DIEGO GAMBETTA, THE SICILIAN MAFIA: THE BUSINESS OF PRIVATE PROTECTION (1993).

politicians are able to extract rents depends strongly on the institutional environment (B). Especially in non-democratic regimes authoritarian leaders may use financially distorting regulations for rent-extraction (C). Summarizing, politicians provide rents to private interest groups in exchange for political support by these groups, necessary for the survival of the politicians (D).

A. *Rent-Extraction and Corruption*

As McChesney argued forty years ago, politicians who control the government should not be viewed "as mere brokers redistributing wealth in response to competing private demands."[82] Rather, they are "independent actors making their own demands to which private actors respond."[83] These politicians may gain by, for example, threatening to impose burdensome regulations on private actors, who therefore have an incentive to strike bargains with these politicians.[84] The result is that regulations are repealed or only enforced in a moderate manner, and politicians are paid for their forbearing from exercising their power to impose costs.[85] In other words, whereas private actors are interested in rent-seeking, politicians are good at rent-extracting.[86] McChesney's rent-extraction theory is further developed by Shleifer and Vishny, who view the governmental intervention in markets as a "grabbing hand" that satisfies the personal interests of politicians rather than a "helping hand" that maximizes social welfare.[87] Similarly, a recent study has shown that excessive regulation, red tape, and bureaucracy are used strategically by incumbent politicians to induce incumbent firms to invest in political connections.[88] In the context of the financial sector, rent-extracting means that politicians who control the government may actively create FDP to extract

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82 Fred S. McChesney, *Rent Extraction and Rent Creation in the Economic Theory of Regulation*, 16 J. LEGAL STUD. 101, 102 (1987).

83 *Id.*

84 *Id.*

85 *Id.* at 30.

86 *See id.*

87 ANDREI SHLEIFER & ROBERT W. VISHNY, THE GRABBING HAND: GOVERNMENT PATHOLOGIES AND THEIR CURES 3, 6 (1998).

88 Giorgio Bellettini, Carlotta Berti Ceroni & Giovanni Prarolo, *Knowing the Right Person in the Right Place: Political Connections and Resistance to Change*, 12 J. EUR. ECON. ASS'N 641, 641–42 (2014).

rents from private actors, such as banks, and then use these rents to enrich themselves or to buy support from certain constituents who are critical to their survival.

It is therefore not surprising to find that empirically, there is a positive connection between government intervention (including but not limited to financial regulation) and corruption.[89] Corruption is defined as "sale by government officials of government property for personal gain"[90] or "acts in which the power of public office is used for personal gain in a manner that contravenes the rules of the game,"[91] and is therefore basically interchangeable with the term of "rent extraction." In a more subtle way, corruption may be further divided into two categories, namely political corruption and bureaucratic corruption.[92] Political corruption refers to the phenomenon that "corrupt political leaders make resource allocation decisions through national policies that serve their own power-preservation goals rather than the interests of their constituents," whereas bureaucratic corruption "occurs when officials take advantage of their professional privilege to receive unsanctioned compensation for performing their job-related duties or for extending additional, extralegal benefits to a payer."[93]

There are indeed many empirical studies pointing at a relationship between (financial) regulation by government and corruption. For example, Treisman measured state intervention by

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89 In the empirical literature, scholars usually use "perceived corruption," which is based on assessments by risk agencies and surveys carried out among elite business people, rather than "experienced corruption," which is based on surveys that ask business people and citizens in different countries whether they have been expected to pay bribes recently. This method is therefore criticized for its subjectivity. *See* Daniel Treisman, *What Have We Learned About the Causes of Corruption from Ten Years of Cross-National Empirical Research?*, 10 ANN. REV. POL. SCI. 211, 237 (2007); Benjamin A. Olken, *Corruption Perceptions vs. Corruption Reality*, 93 J. PUB. ECON. 950 (2009).

90 Andrei Shleifer & Robert W. Vishny, *Corruption*, 108 Q. J. ECON. 599, 599 (1993).

91 Arvind K. Jain, *Corruption: A Review*, 15 J. ECON. SURV. 71, 73 (2001).

92 For a more detailed discussion on the definition, nature, and forms of corruption, *see* JOHANN GRAF LAMBSDORFF, THE INSTITUTIONAL ECONOMICS OF CORRUPTION AND REFORM: THEORY, EVIDENCE, AND POLICY (2007).

93 Marina Zaloznaya, *Does Authoritarianism Breed Corruption? Reconsidering the Relationship Between Authoritarian Governance and Corrupt Exchanges in Bureaucracies*, 40 L. & SOC. INQUIRY 345, 348 (2015); *see also* Benjamin Nyblade & Steven R. Reed, *Who Cheats? Who Loots? Political Competition and Corruption in Japan, 1947-1993*, 52 AM. J. POL. SCI. 926, 927 (2008); Hanne Fjelde & Håvard Hegre, *Political Corruption and Institutional Stability*, 49 STUD. IN COMP. INT'L DEV. 267, 267 (2014).

a variable from the Institute for Management Development's World Competitiveness Report, which records the responses of a survey of executives in top and middle management to the following statement: "State interference does not hinder the development of business in your country."[94] He found that state intervention tends to increase corruption.[95] Other studies find that there is a positive correlation between entry regulation (measured by the number of procedures required for starting a new business for a cross section of eighty-five countries, along with the necessary time and official costs) and corruption.[96] This conclusion is further confirmed by more recent studies.[97]

Certainly, rents can be extracted not only by politicians who enact certain regulations that hurt private enterprises but also by bureaucrats who are responsible for rule enforcement and enrich themselves by selectively implementing these regulations. One study uses a sample of forty-two countries to examine bureaucratic rents (measured by the relative difference in reported life satisfaction between public and private employees).[98] They find that bureaucratic rents are lower when economic regulations are less suffocating (when it is easier to start a business and when price controls are less widespread).[99] They also focus on corruption, which is measured by the perceptions of business executives concerning the frequency of irregular, additional payments connected with import and export permits, business licenses, exchange controls, tax assessments, police protection, or loan applications.[100] They find that bureaucratic rents are higher when

94 Daniel Treisman, *The Causes of Corruption: A Cross-National Study*, 76 J. PUB. ECON. 399, 399 (2000).

95 *Id.* at 436.

96 Simeon Djankov et al., *The Regulation of Entry*, 117 Q. J. ECON. 1, 4 (2002); Jakob Svensson, *Eight Questions about Corruption*, 19 J. ECON. PERSP. 19, 34 (2005).

97 Luca Pieroni & Giorgio d'Agostino, *Corruption and the Effects of Economic Freedom*, 29 EUR. J. POL. ECON. 54, 55 (2013); Nicholas A. Lash & Bala Batavia, *Government Economic Intervention and Corruption*, 47 J. DEV. AREAS 1, 12 (2013); Randall G. Holcombe & Christopher J. Boudreaux, *Regulation and Corruption*, 164 PUB. CHOICE 75, 76–77 (2015).

98 Simon Luechinger, Stephan Meier & Alois Stutzer, *Bureaucratic Rents and Life Satisfaction*, 24 J. L., ECON. & ORG. 476, 481 (2007).

99 *Id.* at 479.

100 *Id.* at 486.

bureaucratic corruption is more prevalent.[101] An important element of the effects of regulatory policy on the level of corruption is the discretion that bureaucrats have in law enforcement. Duvanova examined the relationship between bureaucratic discretion and corruption.[102] The bureaucratic discretion was measured in this study by using the Global Integrity country-level ranking of the effectiveness of supreme audit institutions.[103] The study found that when bureaucratic discretion is low, regulatory burden has a significant negative effect on freedom from corruption, whereas when bureaucratic discretion is high, regulatory burden has no effect on corruption.[104] A later study confirmed these results, showing that the regulatory implementation (in other words the *de facto* regulatory climate) rather than the regulatory policy as such (*de jure* regulatory regime) is responsible for corruption.[105] In the financial sector, bank regulation and supervision are also found to be associated with corruption in bank lending.[106]

Certainly, a positive connection between government intervention (regulation) and corruption does not necessarily mean that government intervention causes corruption. It is reasonable to argue that private actors may use corruption to induce politicians to design certain rules that favor these actors at the cost of social welfare and economic efficiency. Therefore, "a vicious circle can exist whereby inefficient regulation leads to corruption, which in turn cultivates the further spread of troublesome regulation so as to

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101 *Id.* at 480.

102 Dinissa Duvanova, *Bureaucratic Discretion and the Regulatory Burden: Business Environments under Alternative Regulatory Regimes*, 42 BRIT. J. POL. SCI. 573, 573 (2012).

103 *Id.* at 588.

104 *See id.* at 573.

105 Dinissa Duvanova, *Economic Regulations, Red Tape, and Bureaucratic Corruption in Post-Communist Economies*, 59 WORLD DEV. 298, 307 (2014). In this study, regulatory implementation is operationalized with the survey question about the percentage of senior management's time per year spent dealing with business regulation, corruption is operationalized in terms of the percentage of firms' revenues paid unofficially to public officials, and regulatory policy is operationalized in terms of the official number of regulatory procedures required to open a new business as reported by the World Bank Doing Business reports (2003-2006).

106 Thorsten Beck, Asli Demirgüç-Kunt & Ross Levine, *Bank Supervision and Corruption in Lending*, 53(8) J. MONETARY ECON. 2131, 2156–57 (2006); James R. Barth et al., *Corruption in Bank Lending to Firms: Cross-country Micro Evidence on the Beneficial Role of Competition and Information Sharing*, 91 J. FIN. ECON. 361, 361 (2009).

enhance administrative power and the opportunity to extract further payoffs."[107]

B. *Importance of the Institutional Environment*

To what extent politicians and/or bureaucrats can extract rents from the private sector is dependent on the institutional environments that define the incentives faced by these public officials. In a highly developed democracy, where politicians are constrained by the principle of checks and balances and punished by voters for wrongdoings, it is more difficult for politicians to extract rents. This has been shown both theoretically and empirically in various studies. Theoretically Congleton,[108] and Grossman and Helpman[109] have shown that politicians in democracies face a trade-off between positions that maximize rents and positions that serve the general interest. Empirically, Mian, Sufi, and Trebbi[110] find that politicians' voting choice in U.S. legislation is influenced by both constituent interests and campaign contribution, and Dorsch[111] shows that legislators are punished by voters for their behavior of favoring special interests. Empirical evidence equally shows that in democracies, particularly countries with parliamentary systems or with relatively low levels of democracy, incumbent politicians are more likely to be defeated when the perceived level of corruption has increased.[112] However, it is worth noting that whereas democracy helps to tie the grabbing hands of politicians, it is also conducive to the development of interest groups.[113] This development of interest groups is harmful for economic growth.[114]

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107 LAMBSDORFF, *supra* note 92, at 60.

108 Roger D. Congleton, *Campaign Finances and Political Platforms: the Economics of Political Controversy*, 62 PUBLIC CHOICE 101, 114–16 (1989).

109 Gene M. Grossman & Elhanan Helpman, *Electoral Competition and Special Interest Politics*, 63 REV. ECON. STUD. 265, 283–84 (1996).

110 Mian, Sufi & Trebbi, *supra* note 29.

111 Dorsch, *supra* note 31.

112 Stefan Krause & Fabio Mendez, *Corruption and Elections: An Empirical Study for a Cross-Section of Countries*, 21 ECON. & POL. 179, 195–96 (2009).

113 Dennis Coates, Jac C. Heckelman & Bonnie Wilson, *Determinants of Interest Group Formation*, 133 PUB. CHOICE 377, 386 (2007).

114 Dennis Coates, Jac C. Heckelman & Bonnie Wilson, *The Political Economy of Investment: Sclerotic Effects from Interest Groups*, 26 EUR. J. POL. ECON. 208, 208 (2010); Dennis Coates, Jac C. Heckelman & Bonnie Wilson, *Special-Interest Groups and Growth*,

Several studies have therefore, not surprisingly, found that democracy can lower rent extraction (corruption). Emerson reports that more political rights and participation (measured by civil liberties such as the freedom of the press, of religion, and of assembly, political organization, the independence of the judiciary, secure property rights, etc.) have a depressing effect on corruption.[115] Firms also pay bribes with less frequency in countries with better political rights and more developed democracies.[116] Democracy is found to have a negative and significant effect on bureaucratic corruption (referring to private payments to public officials to affect the implementation of already existing rules).[117] In addition to the level of democracy, other studies report the importance of duration of democracy. For example, Treisman reports that the long period of exposure to democracy (rather than the current degree of democracy in a country) is significant to the lowering of corruption.[118] One study reports that both democracy (whether democratically contested elections are held in a country) and democratic stability (time of an uninterrupted democratic regime since 1930 in a country) are associated with lower corruption.[119] Another shows that "long-term democratic rule tends to lead to lower levels of political corruption across the world."[120] Parliamentary democracies and countries with long-standing democratic governments tend to have less corruption.[121] Finally, the process for democratization (the transformation from autocracies to democracies) is generally found to be correlated with a reduction in corruption levels.[122]

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147 PUB. CHOICE 439, 452 (2011).

115 Patrick M. Emerson, *Corruption, Competition and Democracy*, 81 J. DEV. ECON. 193, 211 (2006).

116 Sanford V. Berg, Liangliang Jiang & Chen Lin, *Regulation and Corporate Corruption: New Evidence from the Telecom Sector*, 40 J. COMP. ECON. 22, 32 (2012).

117 Tanya Bagashka, *Unpacking Corruption: The Effect of Veto Players on State Capture and Bureaucratic Corruption*, 67 POL. RES. Q. 165, 176 (2014).

118 Treisman, *supra* note 89.

119 Daniel Lederman, Norman V. Loayza & Rodrigo R. Soares, *Accountability and Corruption: Political Institution Matter*, 17 ECON. & POL. 1, 1 (2003).

120 John Gerring & Strom C. Thacker, *Political Institutions and Corruption: The Role of Unitarism and Parliamentarism*, 34 BRIT. J. POL. SCI. 295, 310 (2004).

121 Randall G. Holcombe & Christopher J. Boudreaux, *Regulation and Corruption*, 164 PUB. CHOICE 75, 81 (2015).

122 Anders Olofsgård & Zaki Zahran, *Corruption and Political and Economic*

Certain studies find that the connection between democracy and corruption may be non-linear. For example, Montinola and Jackman report that democracy has a nonlinear effect on corruption: corruption is likely to be slightly lower in dictatorships than in countries that have partially democratized.[123] But with more complete democratization (reflected in the nature of elections and the effective power of elected legislators), countries experience much lower levels of corruption.[124] This conclusion is further supported by other studies.[125]

In a similar vein, and again not surprisingly, less distorting, more liberal, and more market-oriented policies are more likely to be found in democracies. For example, de Haan and Sturm find that increases in economic freedom between 1975 and 1990 in developing countries can be explained by the level of democracy in these countries in 1975.[126] This conclusion is supported by numerous subsequent empirical studies.[127] However, there are

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Reforms: A Structural Breaks Approach, 20 ECON. & POL. 156, 156 (2008).

123 Gabriella R. Montinola & Robert W. Jackman, *Sources of Corruption: A Cross-Country Study*, 32 BRIT. J. POL. SCI. 147, 167 (2002).

124 *Id.*

125 *See* Michael T. Rock, *Corruption and Democracy*, 45 J. DEV. STUD. 55–75 (2009); Alessandro Pellegata, *Constraining Political Corruption: An Empirical Analysis of the Impact of Democracy*, 20 DEMOCRATIZATION 1195 (2013), and Michael Jetter, Alejandra Montoya Agudelo & Andrés Ramírez Hassan, *The Effect of Democracy on Corruption: Income is Key*, 74 WORLD DEV. 286 (2015).

126 Jakob de Haan & Jan-Egbert Sturm, *Does More Democracy Lead to Greater Economic Freedom? New Evidence for Developing Countries*, 19 EUR. J. POL. ECON. 547, 549–50 (2003).

127 *See* Jan Fidrmuc, *Economic Reform, Democracy and Growth during Post-communist Transition*, 19 EUR. J. POL. ECON. 583 (2003); Hans Pitlik & Steffen Wirth, *Do Crises Promote the Extent of Economic Liberalization?: An Empirical Test*, 19 EUR. J. POL. ECON. 565 (2003); Francesco Giavazzi & Guido Tabellini, *Economic and Political Liberalizations*, 52 J. MONETARY ECON. 1297 (2005); Susanna Lundström, *The Effect of Democracy on Different Categories of Economic Freedom*, 21 EUR. J. POL. ECON. 967–80 (2005); Xavier de Vanssay, Vincent Hildebrand & Zane A. Spindler, *Constitutional Foundations of Economic Freedom: A Time-Series Cross-Section Analysis*, 16 CONST. POL. ECON. 327 (2005); Torsten Persson & Guido Tabellini, *Democracy and Development: The Devil in the Details*, 96 AM. ECON. REV. 319 (2006); Robert A. Lawson & J.R. Clark, *Examining the Hayek–Friedman Hypothesis on Economic and Political Freedom*, 74 J. ECON. BEHAV. & ORG. 230 (2010); Pauline Grosjean & Claudia Senik, *Democracy, Market Liberalization and Political Preferences*, 93 REV. ECON. & STAT. 365 (2011); John Gerring et al., *Democracy, History, and Economic Performance: A Case-Study Approach*, 39 WORLD DEV. 1735 (2011); Paola Giuliano, Prachi Mishra & Antonio Spilimbergo, *Democracy and Reforms: Evidence from a New Dataset*, 5 AM. ECON. J.:

certain disagreements regarding the democracy-economic liberalization nexus. One particular study finds little difference between democracies and non-democracies concerning economic and social policies (such as education spending, social spending, and tax policy), whereas there are indeed differences between democracies and non-democracies in the areas related to political rights (such as practice of torture, use of death penalty, civil liberties, etc.).[128] Others even report that a transition from autocracy to democracy is accompanied by the adoption of anti-liberal policies (agricultural protection).[129]

Certain other studies show that the relationship between democracy and economic freedom is more complicated than suggested by the literature that we have just discussed. One study finds that democratic transition does result in a positive and highly significant impact on economic freedom.[130] However, the path of economic liberalization appears to follow the pattern of an inverted U: there is a significant increase in economic freedom five years after the transition to democracy, and the movement toward liberalization continues through year ten, but economic freedom begins to recede thereafter.[131] In addition, the effect of democracy on economic freedom seems to be conditional on the income distribution within a society: the positive effect of democracy on economic freedom is reinforced by an equal distribution of incomes, whereas the effect is eroded if inequality becomes too high.[132]

Because most of the studies confirming the democracy-economic liberalization nexus use the Economic Freedom of the World summary index[133] as a proxy for economic freedom

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MACROECONOMICS 179 (2013); Mohammad Amin & Simeon Djankov, *Democratic Institutions and Regulatory Reforms*, 42 J. COMP. ECON. 839 (2014).

128 Casey B. Mulligan, Richard Gil & Xavier Sala-i-Martin, *Do Democracies Have Different Public Policies than Nondemocracies?*, 18 J. ECON. PERSP. 51, 71–72 (2004).

129 Alessandro Olper & Valentina Raimondi, *Electoral Rules, Forms of Government and Redistributive Policy: Evidence from Agriculture and Food Policies*, 41 J. COMP. ECON. 141, 141–42 (2013).

130 Martin Rode & James D. Gwartney, *Does Democratization Facilitate Economic Liberalization?*, 28 EUR. J. POL. ECON. 607, 607 (2012).

131 *Id.* at 615.

132 Rainer Kotschy & Uwe Sunde, *Democracy, Inequality, and Institutional Quality*, 91 EUR. ECON. REV. 209, 210 (2017).

133 For examples of other indexes, such as the progress-in-transition indicators published by the European Bank for Reconstruction and Development, see Fidrmuc, *supra*

(liberalization)[134] and two components of this index, i.e., "sound money" and "regulation of credit, labor, and business" measure the extent of governmental intervention in the financial sector, the conclusion of these studies implies that democracies not only have free economic policies in general but also have more liberalized financial policies in particular. Certain other studies focus more specifically on the relationship between democracy and financial liberalization (rather than with general economic policies) and further confirm the positive effects of democracy on financial liberalization. One particular study concludes that "more open, competitive, democratic political systems tend to choose bank supervisory and regulatory strategies that rely more on private monitoring, accept a higher fraction of new bank entry applications, impose fewer regulatory restrictions on what banks can do, and have less of a role for government-owned banks."[135] Another finds that at low levels of democracy, moves to left governments tend to significantly decrease chances of financial liberalization, whereas in more democratic settings, this negative effect of left representation disappears. In other words, democratization significantly mutes the tendency of left governments to oppose financial liberalization.[136]

In contrast, in non-democratic regimes, politicians have both capabilities and incentives to design and implement inefficient economic and financial policies to extract rents from the economy. Politicians have capabilities because the institutional constraints on political power that can be found in democracies are weak or even absent, and politicians have incentives because rents will not only enrich themselves but also, and more importantly, buy support from certain constituents whose loyalty is critical for the survival of the regime (or its ruler). In a non-democratic regime, such as an autocracy, rulers resort to a divide-and-rule strategy to maintain

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note 127; regulation indices compiled by the International Monetary Fund, see Paola Giuliano, Prachi Mishra & Antonio Spilimbergo, *Democracy and Reforms: Evidence from a New Dataset*, 5 AM. ECON. J. MACROECONOMICS 179 (2013); and Doing Business indicators compiled by the World Bank, see Mohammad Amin & Simeon Djankov, *Democratic Institutions and Regulatory Reforms*, 42 J. COMP. ECON. 839 (2014).

134 *See* James Gwartney, Robert Lawson & Joshua Hall, *Economic Freedom of the World*, FRASER INST. (2017) (for the most recent version of this index).

135 BARTH, CAPRIO & LEVINE, *supra* note 9, at 306.

136 Brian Burgoon, Panicos Demetriades & Geoffrey R.D. Underhill, *Sources and Legitimacy of Financial Liberalization*, 28 EUR. J. POL. ECON. 147, 153 (2012).

their rule: members of society need to cooperate to depose an autocrat; however, such cooperation may be defused by punishing any citizen who proposes such a move and bribing those who need to agree to the cooperation.[137] Bribing in turn needs rents.

Even certain democracies (particularly younger democracies) rely on rent distribution as a main governance strategy.[138] But the literature especially stresses the importance of rents in sustaining non-democratic regimes. One study argues that "dictators typically use two instruments to build and maintain political power over the population under their governments. The first instrument involves political repression . . . . Alternatively, dictators can bind parts of the population to them as loyal supporters through the creation and distribution of political rents."[139] Another study similarly contends that dictators usually deploy either of two instruments, repression or economic redistribution, to maintain their rule.[140] The survival strategies of dictators have therefore been described as using some combination of sticks and carrots in order to maintain power, where "carrots, measures that build support or acceptance of the ruler, range from the distribution of rents and patronage to programmatic redistribution and broad-based economic growth. Sticks are coercive or repressive measures that raise the costs of collective action for opponents of the regime."[141] The outcome of such strategies is numerous opportunities that "impoverish many, distort the economy, but enrich the privileged few."[142] With the help of economic rents, the political dominance of a narrow elite, who use their concentrated political power to design extractive economic institutions from the beginning, is further consolidated.[143]

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137 Daron Acemoglu, James A. Robinson & Thierry Verdier, *Kleptocracy and Divide-and Rule: A Model of Personal Rule*, 2 J. EUR. ECON. ASS'N 162, 162 (2004).

138 Philip Keefer, *Clientelism, Credibility, and the Policy Choices of Young Democracies*, 51 AM. J. POL. SCI. 804, 812 (2007).

139 RONALD WINTROBE, THE POLITICAL ECONOMY OF DICTATORSHIP 46 (1998).

140 Stephen Haber, *Authoritarian Government*, *in* THE OXFORD HANDBOOK OF POLITICAL ECONOMY 694 (Barry R. Weingast & Donald A. Wittman eds., 2006).

141 Mary Gallagher & Jonathan K. Hanson, *Coalitions, Carrots, and Sticks: Economic Inequality and Authoritarian States*, 42(4) POL. SCI. & POL. 668 (2009).

142 HILTON L. ROOT, CAPITAL AND COLLUSION: THE POLITICAL LOGIC OF GLOBAL ECONOMIC DEVELOPMENT 37 (2006).

143 *See* DARON ACEMOGLU & JAMES ROBINSON, WHY NATIONS FAIL: THE ORIGINS OF POWER, PROSPERITY, AND POVERTY (2012).

C. Supply of Financially Distorting Regulation

Different policy tools are used by different non-democratic regimes to buy support from different groups. In the former Soviet economies, the main beneficiaries of economic (and political) rents are members of communist parties and bureaucrats. For example, the Soviet-style economy has been described as a rent-seeking system, where rents are offered by the party-state in exchange for loyalty of managers of state-owned enterprises ("SOEs") and officials at every level.[144] It was also found that in the six former Yugoslav republics in the 1953-1988 period, membership of the League of Communists of Yugoslav is positively correlated with unemployment and negatively with real wages, which implies the rent-enjoying status of communist party members.[145] There is equal evidence that in the Soviet Union in the 1930s vehicles (cars and trucks) were allocated by top-leaders to buy support from core constituents.[146] The rent-seeking in a Soviet-style regime has also been modelled as an implicit contract between the rent-maximizing rulers and rent-seeking activists (candidate members of the communist party).[147] According to this model, activists would be induced to work hard (at the lowest rank of the hierarchy) today in exchange for the prospect of promotion to a higher-paid (rent-enjoying) position in the future.[148] That model has been tested and confirmed in a study by Lazarev who finds that the supply of activists is positively affected by the size of the income gap between the party bureaucracy and workers.[149] Another author argues that whereas rent-seeking could not govern the classical socialist society, reduced coercion and loosening of control during perestroika infused the system with rent-seeking and triggered the

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144 Gary M. Anderson & Peter J. Boettke, *Soviet Venality: A Rent-Seeking Model of the Communist State*, 93 PUB. CHOICE 37, 47 (1997).

145 *See generally* Adi Schnytzer & Janez Šušteršič, *Why Join the Party in a One-Party System? Popularity Versus Political Exchange*, 94 PUB. CHOICE 117 (1998) (finding "rents distributed to the population were far more important than the popularity of economic policies and perhaps even more important than repression").

146 Valery Lazarev & Paul Gregory, *Commissars and Cars: A Case Study in the Political Economy of Dictatorship*, 31 J. COMP. ECON. 1, 17 (2003).

147 Valery Lazarev, *Economics of One-Party State: Promotion Incentives and Support for the Soviet Regime*, 47 COMP. ECON. STUD. 346, 349 (2005).

148 *Id.* at 361.

149 Valery Lazarev, *Political Labor Market, Government Policy, and Stability of a Non-Democratic Regime*, 35 J. COMP. ECON. 546, 546 (2007).

collapse of the planned economy.[150]

The situation in contemporary authoritarian regimes is more diversified. The rulers in such regimes may rely on public investment as a vehicle to enrich themselves or maintain power. This is confirmed in a study by Keefer and Knack who report that an increase in the quality of governance is associated with a reduction in public investment, which implies that in countries where governance is weak, "extra public investment . . . [is] largely intended to steer rents to government officials or their cronies."[151] It has also been shown that authoritarian dominant parties continually win elections because they can access and use SOEs, government investment, and other public resources to buy support.[152]

Rulers in authoritarian regimes may also use rents to appease the public by other means. For example, the availability of rents (proxied by non-tax revenues) helps authoritarian governments to expand welfare spending (health, education, housing, unemployment benefits, pensions, and community amenities), thereby realizing an "authoritarian bargain;" i.e., citizens relinquish political rights in exchange for social welfare spending.[153] Rulers could also provide more benefits to workers in exchange for low levels of labor protest. There is indeed evidence that under institutionalized authoritarian regimes (regimes with legislatures and parties), workers take home more income than in non-institutionalized authoritarian regimes; as a result, workers are significantly less likely to strike in institutionalized authoritarian regimes.[154] Authoritarian rulers may equally favor city dwellers at the cost of rural farmers "because city dwellers are politically more

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150 Guinevere Liberty Nell, *Rent-Seeking, Hierarchy and Centralization: Why the Soviet Union Collapsed So Fast and What it Means for Market Economies*, 53 COMP. ECON. STUD. 597, 597 (2011).

151 Philip Keefer & Stephen Knack, *Boondoggles, Rent-Seeking, and Political Checks and Balances: Public Investment under Unaccountable Governments*, 89 REV. ECON. & STAT. 566, 566 (2007).

152 Kenneth F. Greene, *The Political Economy of Authoritarian Single-Party Dominance*, 43 COMP. POL. STUD. 807, 807 (2010).

153 Raj M. Desai, Anders Olofsgård & Tarik M. Yousef, *The Logic of Authoritarian Bargains*, 21 ECON. & POL. 93, 93 (2009).

154 Wonik Kim & Jennifer Gandhi, *Coopting Workers under Dictatorship*, 72 J. POL. 646, 646 (2010).

powerful than rural farmers."[155] They will also often co-opt opposition elites so that their followers can be demobilized. For example, in Russia "when opposition elites hold key leadership position in a legislature, particularly those positions that are related to opportunities for rent-seeking, such as chairmanship of committees of construction, agriculture, economy, industry, property, natural resources, ecology, land, or taxes, protest by groups associated with those elites is reduced."[156] Finally, land distribution can be used to generate political support. For example, in Mexico from 1917 to 1992, land distribution was higher during election years, and land distribution increased support to the governing party (Institutional Revolutionary Party) in Mexican states.[157]

Financial distortions are also used by authoritarian rulers to maintain their power by extending credit to their supporters. For example, during their fast growth period, certain Asian economies, such as Korea and Taiwan, were under authoritarian rule. Authoritarian governments in these economies intentionally distorted the functioning of financial markets so that economic growth could be boosted and therefore legitimacy could be realized. In Amsden's words, in East Asian economies, "economic expansion depends on state intervention to create price distortions that direct economic activity toward greater investment," and in that sense, the state "has set relative prices deliberately 'wrong.'"[158] More importantly, "the most critical price—that for long-term credit—was wildly 'wrong' in a capital-scarce country.[159] A similar conclusion was reached by Wade, who argues that

> government policies deliberately got some prices 'wrong', so as to change the signals to which decentralized agents responded, and also used non-price means to alter the behavior of market agents. The resulting high level of investment generated fast turnover of machinery and hence fast transfer of newer

155 Jeremy Wallace, *Cities, Redistribution, and Authoritarian Regime Survival*, 75 J. POL. 632, 632 (2013).

156 Ora John Reuter & Graeme B. Robertson, *Legislatures, Cooptation, and Social Protest in Contemporary Authoritarian Regimes*, 77 J. POL. 235, 235–36 (2015).

157 Michael Albertus et al., *Authoritarian Survival and Poverty Traps: Land Reform in Mexico*, 77 WORLD DEV. 154, 154, 162 (2016).

158 ALICE H. AMSDEN, ASIA'S NEXT GIANT: SOUTH KOREA AND LATE INDUSTRIALIZATION 13–14 (1992).

159 *Id.* at 144.

technology into actual production.[160]
Despite their growth-enhancing effects, such financial distortions generate enormous economic inefficiency and finally contributed to the eruption of the East Asian financial crisis of 1997-98.[161]

In addition, in such a policy environment, certain banks and enterprises that are closely connected with politicians are also favored. In Japan and Korea, Lukauskas finds that policy makers in these two countries (particularly Korea) "use interest rate and credit controls to channel available funds through a non-price-rationing system to build support among important constituents. They impose heavy reserve requirements, asset restrictions, and other forms of taxation of the banking system to expropriate seigniorage from financial intermediaries and raise government revenue."[162]

A patronage-based credit allocation model can also be observed in many other authoritarian regimes. For example, in Malaysia, firms with political connections had debt ratios that were five percentage points higher than unconnected firms.[163] Similar evidence on advantages of political connections also comes from Pakistan. Using a loan-level data set of more than 90,000 firms in Pakistan between 1996 and 2002, Khawja and Mian find that compared with unconnected firms, politically connected firms borrow 45% more and have 50% higher default rates, and such preferential treatment occurs exclusively in government banks.[164] In Indonesia, the Suharto regime often arranged preferential financing for well-connected firms, who were therefore less dependent on global financial markets (less likely to have publicly traded securities abroad).[165]

Favoring politically connected firms does not only happen in

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160 ROBERT WADE, GOVERNING THE MARKET: ECONOMIC THEORY AND THE ROLE OF GOVERNMENT IN EAST ASIAN INDUSTRIALIZATION 29 (2d paperback ed. 2004).

161 *See* Stephan Haggard, *Governance and Growth: Lessons from the Asian Economic Crisis*, 13 ASIAN PAC. ECON. LIT. 30, 33–38 (1999).

162 Arvid Lukauskas, *Financial Restriction and the Developmental State in East Asia: Toward a More Complex Political Economy*, 35 COMP. POL. STUD. 379, 385 (2002).

163 Simon Johnson & Todd Mitton, *Cronyism and Capital Controls: Evidence from Malaysia*, 67 J. FIN. ECON. 351, 364–65 (2003).

164 Asim Ijaz Khwaja & Atif Mian, *Do Lenders Favor Politically Connected Firms? Rent Provision in an Emerging Financial Market*, 120 Q. J. ECON. 1371, 1371 (2005).

165 Christian Leuz & Felix Oberholzer-Gee, *Political Relationships, Global Financing, and Corporate Transparency: Evidence from Indonesia*, 81 J. FIN. ECON. 411, 415, 436 (2006).

authoritarian regimes. In democratically developing countries, such as Brazil, bank loans are frequently allocated based on political calculation. In Brazil, firms that provide contributions to (elected) federal deputies substantially increase their bank lending (and experienced higher stock returns) than firms that did not around the 1998 and 2002 elections.[166] Also in Brazil, politicians used bank lending to shift employment towards regions that were controlled by their political allies and away from regions without allied incumbents.[167] More generally, Desai and Olofsgård found that in a sample of forty developing countries, politically connected firms benefit from easier access to credit (and other favors, such as lower administrative and regulatory barriers and greater pricing power). These firms, in turn, provide politically valuable benefits to incumbent politicians by maintaining excess labor and paying more taxes.[168]

Even mature democracies have been shown to be susceptible to this disease. In Italy, Sapienza "find[s] that the party affiliation of state-owned banks' chairperson has a positive impact on the interest rate discount given by state-owned banks in the provinces where the associated party is stronger."[169] In the United States, it was reported that the cost of bank loans was significantly lower for Standard & Poors 500 companies that have board members with political ties.[170] More generally, Dinç shows that in a sample of 36 countries (19 emerging markets and 17 developed economies), government-owned banks increase their lending in election years relative to private banks.[171]

In addition to favorable access to financial resources, politically connected firms are also found to be more likely to be bailed out

166 Stijn Claessens, Erik Feijen & Luc Laeven, *Political Connections and Preferential Access to Finance: The Role of Campaign Contributions*, 88 J. FIN. ECON. 554, 554 (2008).

167 Daniel Carvalho, *The Real Effects of Government-Owned Banks: Evidence from an Emerging Market*, 69 J. FIN. 577, 577 (2014).

168 Raj M. Desai & Anders Olofsgård, *The Costs of Political Influence: Firm-Level Evidence From Developing Countries*, 6 Q. J. POL. SCI. 137, 138 (2011).

169 Paola Sapienza, *The Effects of Government Ownership on Bank Lending*, 72 J. FIN. ECON. 357, 380 (2004).

170 Joel F. Houston et al., *Political Connections and the Cost of Bank Loans*, 52 J. ACCT. RES. 193, 193 (2014).

171 I. Serdar Dinç, *Politicians and Banks: Political Influences on Government-owned Banks in Emerging Markets*, 77 J. FIN. ECON. 453, 453 (2005).

than their non-connected peers when facing financial distress.[172] There are also studies that attempt to measure the importance of political factors in allocation of financial resources by analyzing stock market reactions to certain political events, which in general confirm the politics-finance nexus.[173]

In general, Calomiris and Haber conclude that "on average, democracies are more likely to give rise to stable banking systems characterized by relatively open entry and fewer restrictions on banks, while autocracies are more likely to give rise to unstable banking systems characterized by relatively limited entry and more restrictions on banks."[174] Moreover, in authoritarian regimes,

> a system that grants special licenses and privileges to favored bank insiders and restricts entry as part of a larger deal between bank insiders and the autocrat will generally arise. This deal provides a constant flow of a portion of the rents to the government, giving the autocrat a vested interest in the favored banks and thereby reducing the risk of expropriation.[175]

Similarly, Barth, Caprio, and Levine conclude that their empirical evidence is

> consistent with the view that autocratic political regimes establish government-owned banks to funnel credit toward the interest of the ruling elite" and is "consistent with the view that closed political systems that are unaccountable to the public at large will tend to create regulatory restrictions so that bankers need to lobby politicians for special exemptions.[176]

Financial distortions may benefit authoritarian rulers in the short term but endanger their rule in the long-run because distorted financial regulations and policies will inhibit financial development, and slower financial development, as we have argued at the beginning of this paper, will damage long-term economic

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172 Mara Faccio, Ronald W. Masulis & John J. McConnell, *Political Connections and Corporate Bailouts*, 61 J. FIN. 2597, 2597 (2006); *see also* Mian, Sufi & Trebbi, *supra* note 29; Deniz Igan, Prachi Mishra & Thierry Tressel, *A Fistful of Dollars: Lobbying and the Financial Crisis*, 26 NBER MACROECONOMICS ANN. 195, 230 (2012).

173 *See* Raymond Fisman, *Estimating the Value of Political Connections*, 91 AM. ECON. REV. 1095, 1095–96 (2001); Mara Faccio, *Politically Connected Firms*, 96 AM. ECON. REV. 369, 369 (2006).

174 CHARLES W. CALOMIRIS & STEPHEN H. HABER, FRAGILE BY DESIGN: THE POLITICAL ORIGINS OF BANKING CRISES AND SCARCE CREDIT 40 (2014).

175 *Id.* at 45.

176 BARTH, CAPRIO & LEVINE, *supra* note 9, at 305.

growth. Indeed, there is evidence showing that financial development is easier to achieve in democracies[177] rather than in authoritarian regimes.

Bordo and Rousseau explore the relationship between financial development and the political environment in a historical cross-section of seventeen countries covering the period from 1880 to 1997 and find that "political variables such as proportional representation election systems, frequent elections, and infrequent revolutions or coups are consistent with larger financial sectors."[178] Another study uses panel data on both developed and developing countries from 1975 to 2000 to examine the effect of a country's democracy characteristics and regime change on financial development, and find that both regime stability and democracy promote financial development.[179] Huang employs a panel dataset of ninety developed and developing countries over 1960-1999 showing that a democratic transformation is typically followed by an increase in financial development.[180]

It should also be noted that certain studies show that the connection between democracy and financial development is more complicated than that suggested by previous literature. For example, Quintyn and Verdier find that whether a financial

177 However, democratic countries are not homogeneous with respect to such factors as distribution of power, social ideology, preference of median voters, etc. The differences in these dimensions will further influence the direction, speed, and stability of financial development. *See* Victor Menaldo & Daniel Yoo, *Democracy, Elite Bias, and Financial Development in Latin America*, 67 WORLD POL. 726, 727 (2015) (finding "elite based democracies," or those with constitutions inherited from prior authoritarianism, to be "less financially developed" than popular democracies, or those with their own democratically created or amended constitutions). Enrico C. Perotti & Ernst-Ludwig von Thadden, *The Political Economy of Corporate Control and Labor Rents*, 11 J. POL. ECON. 145, 147 (2006) (explaining the effect of median voters on financial development); MARK J. ROE, POLITICAL DETERMINANTS OF CORPORATE GOVERNANCE: POLITICAL CONTEXT, CORPORATE IMPACT 1 (2003); Marianna Belloc & Ugo Pagano, *Co-evolution of Politics and Corporate Governance*; 29 INT'L REV. L. & ECON. 106, 106 (2009) (explaining the effects of social ideology on financial development); Marco Pagano & Paolo F. Volpin, *The Political Economy of Corporate Governance*, 95 AM. ECON. REV. 1005, 1005 (2005) (explaining the effect of electoral systems on financial development).

178 Michael D. Bordo & Peter L. Rousseau, *Legal-Political Factors and the Historical Evolution of the Finance-Growth Link*, 10 EUR. REV. ECON. HIST. 412, 440 (2006).

179 Sourafel Girma & Anja Shortland, *The Political Economy of Financial Development*, 60 OXFORD ECON. PAPERS 567, 567 (2007).

180 Yongfu Huang, *Political Institutions and Financial Development: An Empirical Study*, 38 WORLD DEV. 1667, 1667 (2010).

acceleration can finally lead to long-term financial deepening depends on the quality of political institutions.[181] Campos and Coricelli show that there is a non-monotonic relationship between democracy and financial development because the lowest level of financial development tends to occur in intermediate regimes of "partial democracy."[182] Therefore, during the democratization process, when the system travels from autocracy to partial democracy, financial development is likely to go through reversals. Similarly, Law and Azman-Saini report a non-linear relationship between political institutions and stock market development.[183]

D. *Summary*

In summary, rents created by FDP are crucial for politicians, particularly politicians in non-democracies, where political influence is concentrated. Support from certain politically influential groups is critical for the survival of these politicians. They therefore have strong incentives (and capabilities) to design and implement certain inefficient financial policies, such as entry barriers that benefit incumbent banks, cheap credit that benefits certain enterprises with political connections, and targeted bank loans that benefit certain regions where their core constituents are located. Consequently, financial resource allocation is distorted, economic efficiency is damaged, and the foundation of long-term economic growth is undermined.

IV. The Interaction between Demand and Supply

The evidence seems to suggest that influence from the demand side (interest groups) plays a more important role in shaping distorted financial policies in democracies, and the government, as the supplier of financial policies, should be blamed for being responsible for financial distortions in non-democracies. It is not a surprising conclusion, given that politicians are more constrained and interest groups are more prevalent and active in democracies.[184]

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181 Marc Quintyn & Genevieve Verdier, *Mother, Can I Trust the Government? Sustained Financial Deepening-A Political Institutions View* 19 (IMF Working Paper, WP/10/210 2010).

182 Nauro Campos & Fabrizio Coricelli, *Financial Liberalization and Reversals: Political and Economic Determinants*, 27 ECON. POL'Y 483, 486, 508 (2012).

183 *See* Siong Hook Law & W.N.W. Azman-Saini, *Institutional Quality, Governance, and Financial Development*, 13 ECON. GOVERNANCE 217, 217 (2012).

184 *See* Coates, Heckelman & Wilson, *supra* note 113, at 386 (discussing the

However, it would be wrong to then argue that politicians are completely passive in democracies and that interest groups play no role in non-democracies. As the evidence shows, politicians in democracies also intentionally and actively use financial resources (such as bank loans) to reward their supporters. We provided studies showing empirical evidence of that in the previous section. Even in a developed democracy such as the United States, there are claims that the political-economic system is "crony capitalism" in which the "government protects and subsidizes powerful corporations and in (implicit) exchange, the government uses those businesses to carry out government policies outside of the ordinary processes of government."[185] Similarly, powerful interest groups, particularly wealthy families, or economic oligarchies wield significant clout in non-democratic regimes by colluding with or even controlling politicians. For example, "in 2000, the Russian oligarchs took over the Russian Union of Industrialists and Entrepreneurs (RSPP)."[186] Since then, "RSPP's leaders have regularly met with President Putin to discuss economic policy . . . [and] provided advice to the government and parliament on legislative changes; on several occasions, RSPP even drafted and put forward important pieces of legislation."[187] The oligarchies in Russia are so powerful that it is claimed that there is a "state capture," which is defined as "the efforts of firms to shape the formation of the basic rules of the game (i.e. laws, rules, decrees and regulations) through illicit and non-transparent private payments to public officials."[188] Similar evidence came from Korea (before its democratization), where the industrial conglomerates known as *chaebol* were so politically influential that Lukauskas concludes that "selective credit policy was highly politicized and it was no longer possible to specify whether the *chaebol* or the government actually controlled Korea's credit allocation policy."[189]

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connection between political systems and interest group formation).

185 Todd Zywicki, *Rent-Seeking, Crony Capitalism, and the Crony Constitution*, 23 SUP. CT. ECON. REV. 77, 77 (2015).

186 Sergei Guriev & Andrei Rachinsky, *The Role of Oligarchs in Russian Capitalism*, 19 J. ECON. PERSP. 131, 145 (2005).

187 *Id.*

188 Joel S. Hellman, Geraint Jones & Daniel Kaufmann, *Seize the State, Seize the Day: State Capture and Influence in Transition Economies*, 31 J. COMP. ECON. 751, 756 (2003).

189 Lukauskas, *supra* note 162, at 396.

Both political and economic elites in Korea are powerful enough to harm the other, which leads to a "mutual hostage situation."[190] Across the world, wealthy families' control over large corporations and banks seems to be a prevalent phenomenon.[191] Such a control, unfortunately, leads to significant economic inefficiency, social injustice, and political irresponsibility.[192]

Therefore, it is safer to conclude that both demand and supply factors matter for understanding the existence and continuance of FDP and that which factor dominates depends on the institutional context within which demand and supply factors function, such as the constitutional framework of a country; the political accountability, responsibility, and responsiveness of a government; and the relationship among government, business, society, etc. Moreover, demand and supply factors may influence, complement, and reinforce each other, and such complementarity may further lead to multiple equilibria, i.e., rent-seeking by interest groups and rent extraction by politicians are constrained in certain environments, whereas interest groups and politicians are unscrupulous in other environments.[193]

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190 David C. Kang, *Transaction Costs and Crony Capitalism in East Asia*, 35 COMP. POL. 439, 442 (2003).

191 Randall Morck, Daniel Wolfenzon & Bernard Yeung, *Corporate Governance, Economic Entrenchment, and Growth*, 43 J. ECON. LITERATURE 3 655, 657–60 (2005) (discussing the ubiquity with which a relatively small number of families control the corporate sectors in most of the world's economies); Gerard Caprio, Luc Laeven & Ross Levine, *Governance and Bank Valuation*, 16 J. FIN. INTERMEDIATION 584, 595 (2007) (pointing out that in the average country, a single family is the controlling owner in 52% of banks with a controlling owner); Randall Morck, M. Deniz Yavuz & Bernard Yeung, *Banking System Control, Capital Allocation, and Economy Performance*, 100 J. FIN. ECON. 264, 265 (2011) (discussing performance based on family control of banking institutions).

192 Kathy Fogel, *Oligarchic Family Control, Social Economic Outcomes, and the Quality of Government*, 37 J. INT'L BUS. STUD. 603, 617 (2006).

193 *See* Joel S. Hellman & Mark Schankerman, *Intervention, Corruption and Capture: The Nexus Between Enterprises and the State*, 8 ECON. TRANSITION 545 (2000) (reporting that state capture by interest groups and state intervention to extract rents are complementary on the macro level in transition economies); O. Becerra, E. Cavallo & C. Scartascini, *The Politics of Financial Development: The Role of Interest Groups and Government Capabilities*, 36 J. BANKING & FIN. 626, 632–33, 639 (2012) (finding that, in a sample of ninety-seven countries, the influence of interest groups on financial development is dependent on government capabilities (measured by the quality of the bureaucracy)); Michael S. Rocca & Stacy B. Gordon, *Earmarks as a Means and an End: The Link between Earmarks and Campaign Contributions in the U.S. House of Representatives*, 75 J. POL. 241–53 (2012) (showing that members of U.S. Congress use earmarks to reward loyal contributors, whereas interest groups attract earmarks by

V. China as a Case Study

In this section, we use China as a case study to illustrate our framework because China's financial policies are among the most distorting across the world. According to Huang and Ji, "China's financial liberalization is among the lowest in the world."[194] More specifically, the banking sector continues to be dominated by state ownership.[195] In addition, interest rates are still influenced by the government. Even though interest rate liberalization was formally completed in China by 2015, Tan, Ji, and Huang caution that

> the de jure completion of interest rate liberalization has generated little impact on the Chinese financial system . . . commercial banks still stick to the official benchmark rates set by the PBOC, although they are not required to do so anymore, at least in theory. Both deposit rates and loan rates have stayed nearly the same as those before reform.[196]

Moreover, credit allocation in China is also heavily influenced and is more determined by political factors than by commercial motives. Because of political influence, there is "a systemic, pervasive, persistent bias in financial policies in favor of the least efficient firms in the Chinese economy-SOEs-at the expense of the most efficient firms in the Chinese economy-China's small, entrepreneurial, and private enterprises."[197] In other words, "the lending policy and practices of China's formal financial institutions were designed to deter, if not entirely block, the rise of the private

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contributing to legislators' campaigns); Russell S. Sobel & J.R. Clark, *Interest Group Activity and Government Growth: A Causality Analysis*, 36 CATO J. 3, 507–33 (2016) (reporting that in the United States, there is a bidirectional causality between federal spending and two measures of the value of resources devoted to interest group activity [lobbying expenditure and the payroll of political/lobbying organizations located in Washington, D.C.]); Debraj Ray, *What's New in Development Economics?*, 44 AM. ECONOMIST 2, 3–16 (2000) (for a more general discussions on the relationship between complementarity and multiple equilibria); Xavier Vives, *Complementarities and Games: New Developments*, 43 J. ECON. LITERATURE 437, 438–39 (2005).

194 Yiping Huang & Yang Ji, *How will Financial Liberalization Change the Chinese Economy? Lessons from Middle-income Countries*, 50 J. ASIAN ECON. 27, 29 (2017).

195 Barry Naughton, *Is China Socialist?*, 31 J. ECON. PERSP. 3, 8 (2017) (reporting that by 2014, the Chinese government controlled at least 85% of banking sector assets).

196 Yuyan Tan, Yang Ji & Yiping Huang, *Completing China's Interest Rate Liberalization*, 24 CHINA & WORLD ECON. 1, 2 (2016).

197 Yasheng Huang, *Do Financing Biases Matter for the Chinese Economy?*, 26 CATO J. 287, 289 (2006).

enterprise economy."[198]

The argument that the private sector is financially disfavored in China is further supported by certain statistical evidence. For example, Brandt and Li found that compared with township and village enterprises ("TVEs"), which are set up and owned by local township governments, private firms (as well as later privatized TVEs) were significantly less likely to obtain loans, received smaller loans, and were subject to higher loan standards.[199] For unlisted manufacturing firms in China, state ownership is found to be still significantly and positively associated with a firm's likelihood of having long-term debt (but not short-term debt), as well as a higher leverage ratio.[200] Based on a data set covering more than 20,000 Chinese firms over the 1998 to 2005 period, Poncet, Steingress, and Vandenbussche find that private firms significantly relied on their cash flow to finance their investment, which is evidence of credit constraints, whereas SOEs did not.[201] The financial discrimination against private enterprises appears to have continued or even worsened after 2008, when the Chinese government adopted a gigantic stimulus plan, which favored infrastructural projects as well as other local-government-sponsored projects.[202]

These distorted financial policies have severely undermined China's prospects of economic growth by misallocating financial resources. There is large evidence of the negative economic consequences of this financial misallocation. Bas and Causa find

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198 VICTOR NEE & SONJA OPPER, CAPITALISM FROM BELOW: MARKETS AND INSTITUTIONAL CHANGE IN CHINA 96 (2012).

199 Loren Brandt & Hongbin Li, *Bank Discrimination in Transition Economies: Ideology, Information, or Incentives?*, 31 J. COMP. ECON. 387, 388–91 (2003).

200 Kai Li, Heng Yue & Longkai Zhao, *Ownership, Institutions, and Capital Structure: Evidence from China*, 37 J. COMP. ECON. 471, 475 (2009).

201 Sandra Poncet, Walter Steingress & Hylke Vandenbussche, *Financial Constraints in China: Firm-Level Evidence*, 21 CHINA ECON. REV. 411, 412 (2010).

202 *See* Risto Herrala & Yandong Jia, *Toward State Capitalism in China?*, 14 ASIAN ECON. PAPERS 163 (2015) (discussing economic policies that favored state capitalism as opposed to a private market economy); Anders C. Johansson & Xunan Feng, *The State Advances, the Private Sector Retreats? Firms Effects of China's Great Stimulus Programme*, 40 CAMBRIDGE J. ECON. 1635 (2016) (finding that state enterprises had better access to short and long-term loans than private sector enterprises after the economic policy change of 2008); Ivan Roberts & Andrew Zurawski, *Changing Patterns of Corporate Leverage in China: Evidence from Listed Companies*, *in* 1 CHINA'S NEW SOURCES OF ECONOMIC GROWTH 271 (2016).

that aligning financial policies in China to the average level observed in OECD countries would result in labor productivity gains of 6.5% in the manufacturing sector.[203] It was also reported that between 1985 and 2007, capital and labor misallocation lowered aggregate non-agricultural TFP by an average of 20%, with capital misallocation accounting for more than half of the total loss.[204] Another study shows that policy distortions in financial markets caused an aggregate TFP loss of 19.2%.[205] Several empirical studies therefore show that financial distortions have been harmful to China's economic growth.[206]

In this section we will test the previously presented theoretical model explaining the emergence of financially distorting regulation for the case of China. We first focus on the role of the Chinese Party-State (A) as the supplier of financially distorting regulation; next we discuss the role of interest groups on the demand-side of

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203 Maria Bas & Orsetta Causa, *Trade and Product Market Policies in Upstream Sectors and Productivity in Downstream Sectors: Firm-Level Evidence from China*, 41 J. COMP. ECON. 843, 845 (2013).

204 Loren Brandt, Trevor Tombe & Xiaodong Zhu, *Factor Market Distortions Across Time, Space, and Sectors in China*, 16 REV. ECON. DYNAMICS 39, 52 (2013).

205 Guiying (Laura) Wu, *Capital Misallocation in China: Financial Frictions or Policy Distortions?*, 130 J. DEV. ECON. 203, 211 (2018).

206 *See* Genevieve Boyreau-Debray, *Financial Intermediation and Growth: Chinese Style* (World Bank Policy Research Working Paper No. 3027 2003) (suggesting that state-level credit of the banking industry actually harmed provincial economic growth); *see also* Alessandra Guariglia & Sandra Poncet, *Could Financial Distortions Be No Impediment to Economic Growth after All? Evidence from China*, 36 J. COMP. ECON. 633–57 (2008); Diego Anzoategui, Mali Chivakul & Wojciech Maliszewski, *Financial Distortions in China: A General Equilibrium Approach* (IMF Working Paper, WP/15/274 2015). *But see* Yiping Huang & Xun Wang, *Does Financial Repression Inhibit or Facilitate Economic Growth? A Case Study of Chinese Reform Experience*, 73 OXFORD BULL. ECON. & STATS. 833–55 (2011) (finding that the role of FDP is more complicated. Huang and Wang show that the connection between financial distortions and economic growth is changeable: they initially promoted economic growth in the 1980s and 1990s but have inhibited economic growth over the 2000s); *see also* Guangdong Xu & Binwei Gui, *The Connection between Financial Repression and Economic Growth: The Case of China*, 12 J. COMP. ASIAN DEV. 385 (2013) (demonstrating that China's distorted financial system acts as a double-edged sword: interest rate controls contribute to economic growth by lowering the cost of capital, and exchange rate distortion promotes economic growth by stimulating exports; conversely, credit misallocation and state ownership in the banking sector retard economic growth by damaging economic efficiency); Guangdong Xu & Binwei Gui, *Does Financial Repression Retard China's Economic Growth? An Empirical Examination*, *in* THE ROLE OF LAW AND REGULATION IN SUSTAINING FINANCIAL MARKETS 73, 73–97 (Niels Philipsen & Guangdong Xu eds., 2014).

regulation in China (B).

A. The Role of the Chinese Party-State

1. Promoting Inefficient SOEs

China is certainly a non-democratic regime. China specialists have used different labels to describe the essential nature of the regime, such as "market-Leninism," "neo-Leninism," "soft-authoritarianism," "neo-authoritarianism," "resilient-authoritarianism," and "developmental autocracy."[207] Regardless of the terms used by these specialists, a consensus reached is that, at its core, China remains a Leninist party-state in which the Communist Party of China (hereafter "the Party") plays the leading role in political life and enjoys a monopoly of power by excluding all other parties. According to the Polity IV scale, which is a score assigned to each country based on its level of democracy versus autocracy within its political system, with 10 indicating "strongly democratic" and -10 indicating "strongly autocratic," China's score in 2010 was -7.[208] As we have shown in the previous section, financial distortions have been used by authoritarian leaders to sustain their rule by allocating financial resources to their supporters. This logic also applies to China. The Party establishes a patronage system through which loyalty and support can be bought by material and non-material benefits, which in turn demand an economic system in which economic rents can be created continually, distributed selectively, and protected effectively. FDP are part of the story.

State-related institutions, particularly SOEs, are perhaps the most important mechanism through which economic rents and loyalty can be exchanged. The role of SOEs in maintaining the communist regime is so important that they are identified as belonging to the core of the party-state complex of elite institutions.[209] Tsai and Naughton similarly argue that "State-owned firms have emerged as a crucial component of a revitalized Communist Party system, and SOEs are looked on with renewed

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207 Minxin Pei, *How China Is Ruled?*, 3 AM. INT. 44, 48 (2008).

208 *See* POLITY IV COUNTRY REPORT 2010: CHINA, http://www.systemicpeace.org/polity/China2010 [https://perma.cc/G8JW-NT7C].

209 Barry Naughton, *Inside and Outside: The Modernized Hierarchy that Runs China*, 44 J. COMP. ECON. 404, 410–11 (2016).

favor as one of the pillars of this revitalized but still authoritarian and hierarchical system."[210] In Pei's words, "without its ability to hand out economic rents, the Party would surely lose the loyalty of its supporters and its ability to retain power. Thus, the Party keeps extensive and tight control over China's state-owned enterprises so that it can dole out political patronage."[211] In the reform and open-up era, the Party successfully recreated a system of political patronage when the process of economic reform and market transition took away the monopoly over the distribution of patronage resources that political elites had enjoyed before 1978, and SOE-related jobs and incomes constitute an important component of this new system.[212]

On the management level, CEOs of SOEs, particularly of SOEs controlled by the central government (the so-called central SOEs, "CSOEs"), are rewarded with high income and elite positions inside the party-state for their loyalty and support. These SOEs are supervised by the State-owned Assets Supervision and Administration Commission ("SASAC"), an authority that was established by the State Council in 2003 to undertake the government's functions as investor and owner of state assets. The other SOEs are supervised by local SASACs.[213] In terms of income, an article shown on the website of the China Daily, which is the mouthpiece of the Chinese government, claims that

> [s]tatistics showed the average annual salary of executives at centrally administered SOEs ranged from 600,000 ($105,691) to 700,000 yuan in 2010 and 2011. Considering that some SOEs prosper on state support, these salaries were unreasonably higher than those of government civil servants. In addition to the much-envied high salaries, what has most irritated the public has been the so-called 'invisible income,' such as transportation and

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210 Kellee S. Tsai & Barry Naughton, *Introduction*, *in* STATE CAPITALISM, INSTITUTIONAL ADAPTATION, AND THE CHINESE MIRACLE 10, 10–11 (Barry Naughton & Kellee S. Tsai eds., 2015).

211 Minxin Pei, *Is CCP Rule Fragile or Resilient?*, 23 J. DEMOCRACY 27, 33–34 (2012).

212 Barry Naughton, *A Political Economy of China's Economic Transition*, *in* CHINA'S GREAT ECON. TRANSFORMATION 91, 95 (Loren Brandt & Thomas G. Rawski eds., 2008).

213 *See* Guangdong Xu & Binwei Gui, *Why are China's State-Owned Enterprises so Profitable? A Financial Repression Perspective*, *in* MARKET INTEGRATION: THE EU EXPERIENCE AND IMPLICATIONS FOR REGULATORY REFORM IN CHINA (Niels Philipsen, Stefan E. Weishaar & Guangdong Xu eds., 2016).

communication allowances and other material benefits that SOE officials enjoy.[214]

In terms of positions, a number of positions in several elite government and party bodies is reserved for leaders of the CSOEs: twenty-two managers were nominated as representatives to the Eleventh National People's Congress (legislature), and ninety-nine managers, to the Eleventh Chinese People's Political Consultative Conference ("CPPCC").[215] According to the Chinese government, the CPPCC "is an organization of the patriotic United Front of the Chinese people" and "conducts political consultations on major state policies and important issues concerning the well-being of the people, and exercises democratic supervision through proposals and criticisms."[216]

A significant number of leaders from CSOEs are also represented in important Party platforms,[217] such as the Central Committee.[218] For workers of SOEs, compared with their counterparts in the private sector, their average wage level is much higher (CNY 23,565 versus CNY 14,096 in 2007), and the growth rate of their average wage is also faster (259.8% versus 178.2% between 1992 and 2007).[219] Therefore, it is not surprising to find

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214 *China Targets High Salaries at State Firms*, CHINA DAILY (Aug. 20 2014, 11:23 A.M.) http://www.chinadaily.com.cn/business/2014-08/20/content_18453862.htm [https://perma.cc/F6FK-RYCG].

215 Li-Wen Lin & Curtis J. Milhaupt, *We Are the (National) Champions: Understanding the Mechanisms of State Capitalism in China*, 65 STAN. L. REV. 697, 727 (2013).

216 *Chinese People's Political Consultative Conference: Process of Founding and Key Achievements in History,* NAT'L PEOPLE'S CONG., http://www.china.org.cn/english/27750.htm [https://perma.cc/5Q38-QESB]. *But see* Minglu Chen, *From Economic Elites to Political Elites: Private Entrepreneurs in the People's Political Consultative Conference*, 24 J. CONTEMP. CHINA 613, 616 (2015) (the CPPCC and its local branches are commonly viewed as a "flower vase" or rubber-stamp organization with no real power except to window dress).

217 *See* Jianyu Wang, *The Political Logic of Corporate Governance in China's State-Owned Enterprises*, 47 CORNELL INT'L L. J. 631, 660 (2014) (reporting that as of 2010, twenty-three of China's thirty-one provinces had governors or vice governors who had worked as SOE executives. For these former executives, the new positions "greatly extend their career ladders in the party-state hierarchy, bringing them more prestige and a higher political status").

218 Kjeld Erik Brødsgaard, *Politics and Business Group Formation in China: The Party in Control?*, 211 CHINA Q. 624, 625 (2012).

219 Suqin Ge & Dennis Tao Yang, *Changes in China's Wage Structure*, 12 J. EUR. ECON. ASS'N. 300, 308 (2014).

that employees in the state sector show more support for the party-state than their counterparts in the private sector. Chen and Lu report that

> there was a significant, negative correlation between employment in the state apparatus and support for democracy and democratization within the general population. In other words, those who were employed by the state sector (government and party agencies, state-owned enterprises, and public organizations) were less likely to support democracy than those who worked outside of the state sector.[220]

Given the authoritarian nature of the current regime, rejection of democracy seems to imply consent for the status quo.[221]

Motivated by the economic and political benefits and constrained by the control and discipline from the Party, SOEs serve the interests of the Party enthusiastically and effectively. For example, they are shown to help achieve social stability by maintaining employment.[222] Given the inefficiency[223] and the heavy policy burden (such as maintaining employment), it is hard for SOEs to survive without certain governmental support, not to mention profiting. Indeed, China's SOEs were so inefficient in the

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220 Jie Chen & Chunlong Lu, *Democratization and the Middle Class in China: The Middle Class's Attitude toward Democracy*, 64 POL. RES. Q. 705, 715 (2011).

221 *Id.* at 710.

222 Xianfen Huang, Ping Li & Richard Lotspeich, *Economic Growth and Multi-tasking by State-Owned Enterprises: An Analytic Framework and Empirical Study Based on Chinese Provincial Data*, 34 ECON. SYS. 160, 161 (2010); *see also* Alexander Ljungqvist et al., *State Capitalism vs. Private Enterprise* (NBER Working Paper, No. 20930 2015).

223 *See* JANOS KORNAI, THE SOCIALIST SYSTEM: THE POLITICAL ECONOMY OF COMMUNISM (1992) (discussing the inefficiency of SOEs in general); Andrei Shleifer, *State versus Private Ownership*, 12 J. ECON. PERSP. 133, 138 (1998); *see also* William L. Megginson & Jeffry M. Netter, *From State to Market: A Survey of Empirical Studies on Privatization*, 39 J. ECON. LITERATURE 321, 380 (2001) (concluding that "research now supports the proposition that privately owned firms are more efficient and more profitable than otherwise-comparable state-owned firms"); Martin Hovey & Tony Naughton, *A Survey of Enterprise Reforms in China: The Way Forward*, 31 ECON. SYS. 138, 138–40 (2007) (concluding that "ownership structure does significantly influence the performance and value of Chinese firms" and that "state ownership is generally negatively correlated to performance"); SHAHID YUSUF, KAORU NABESHIMA & DWIGHT H. PERKINS, UNDER NEW OWNERSHIP: PRIVATIZING CHINA'S STATE-OWNED ENTERPRISES 14 (2006) (positing that "studies extending back into the latter half of the 1980s have repeatedly shown that the efficiency and productivity of SOEs lag behind COEs [collectively owned enterprises], TVEs [township and village enterprises], and joint ventures").

1990s that almost half were running losses. Subsequent divestment and/or closure of thousands of small and medium-size SOEs improved the situation, although 30% of the surviving SOEs remained in the red in 2002.[224] The situation has changed drastically during the past decade, and the profitability of China's SOEs has increased impressively. The reported average return on equity ("ROE") of an SOE in China jumped from only 2.2% in 1996 to 15.7% in 2007 before sliding back to 10.9% in 2009.[225] From 2003 to 2011, the net profits of China's SOEs increased from CNY 320 billion to CNY 1.9 trillion, based on average annual growth of 25.2%.[226] However, an increasing amount of evidence shows that the major driving force behind the profitability of China's SOEs consists of certain distorted economic policies that favor SOEs at the expense of private enterprise development and the greater social welfare. Several studies have argued that Chinese SOEs have been highly profitable over the past decade because they enjoy monopolies in upstream industries such as energy, raw materials, banks, and telecommunications, whereas the downstream industries such as manufacturing and other tradable sectors are largely liberalized.[227] As a consequence, in this vertical structure, upstream SOEs are able to accumulate profits by extracting monopoly rents from the downstream private sector businesses.[228] The rent-seeking by SOEs was possible also as a result of financially distorting regulation, the central topic of this article.

In 2011, the Unirule Institute of Economics, a Beijing-based independent think tank, issued a report systematically examining the subsidies enjoyed by SOEs during the 2001-2009 period.[229]

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224 YUSUF, NABESHIMA & PERKINS, *supra* note 223, at 14.

225 *China 2030: Building a Modern, Harmonious, and Creative High-Income Society*, WORLD BANK AND THE DEVELOPMENT RESEARCH CENTER OF THE STATE COUNCIL, CHINA 105 (2013).

226 *China SOEs Report Surge in Profits*, CHINA DAILY (Oct. 24, 2012), http://www.chinadaily.com.cn/business/2012-10/24/content_15843638.htm [https://perma.cc/F4ED-WVKF].

227 Xi Li, Xuewen Liu & Yong Wang, *A Model of China's State Capitalism* 4 (H.K. U. Sci. & Tech., Working Paper No. 2015-12, 2015), https://iems.ust.hk/assets/publications/working-papers-2015/iemswp2015-12.pdf [https://perma.cc/UY2Q-D4GY]; Julan Du & Yong Wang, *Reforming SOEs under China's State Capitalism*, *in* UNFINISHED REFORMS IN THE CHINESE ECONOMY 5–6 (June Zhang ed., 2013).

228 *Id.* at 4.

229 *See* HONG SHENG & NONG ZHAO, CHINA'S STATE-OWNED ENTERPRISES: NATURE,

According to this report, from 2001 to 2009, SOEs paid CNY 305.98 billion less, on average, than what they should have paid out as interest rates annually.[230] In addition to lower interest rates, SOEs also received other subsidies, including unpaid rents for nationally owned lands that were given to SOEs at no cost or very low prices, unpaid rents for nationally owned natural resources (such as oil, natural gas and coal) that were extracted by SOEs at very low prices, and direct governmental fiscal subsidies.[231] From 2001 to 2009, the total subsidies directed to SOEs were CNY 6,144.3 billion.[232] If the benefits derived from governmental policies favoring SOEs were deducted from their nominal profits, the real profits of Chinese SOEs would be in fact negative in the period from 2001 to 2009.[233] In total, for the nine years from 2001 to 2009, CNY 2,753.85 billion was not paid out as interest rates but was instead appropriated by SOEs and included in their nominal profits.[234] We also attempt to estimate the scale of subsidies that flowed to SOEs from China's banking sector, or more precisely, from Chinese citizens through the banking sector in our previous work.[235] We found that subsidies (rents) from FDP are greater than the profits earned by SOEs in most years from 1978 to 2012 if we assume that the real market interest rate is 10%.[236] Even if we follow Caprio, Atiyas, and Hanson, who argue that financial distortions would most likely drive down interest rates by two percentage points,[237] and therefore use 2% as the interest rate spread in most years, the financial distortion rents remain more than 30% of the profits earned by SOEs.[238]

PERFORMANCE, AND REFORM xxi (2012).

230 *Id.*

231 *Id.* at 184.

232 *Id.* at xxii.

233 *Id.* at 68.

234 *Id.*

235 *See* Xu & Gui, *Why are China's State-Owned Enterprises so Profitable?*, *supra* note 213, at 146.

236 For a discussion on the reason for choosing 10% as the real market interest rate, see Haibing Gu, Hongyan Shi & Wei Liu, *woguo yinhang daikuan lilv de jiegouxing fenxi (A Structural Analysis of the Banks' Lending Rates in China)*, 3 XUESHU YANJIU (ACADEMIC RESEARCH) 62–65 (2006).

237 GERARD CAPRIO JR., IZAK ATIYAS & JAMES A. HANSON, FINANCIAL REFORM: THEORY AND EXPERIENCE 92 (1996).

238 *See* Xu & Gui, *Why are China's State-Owned Enterprises so Profitable?*, *supra* note 213, at 158.

2. *Co-opting Private Enterprises*

In addition to supporting the patronage system, the Party also needs FDP to co-opt new social groups (such as private entrepreneurs) whose economic power and social influence may finally become a threat to the dominance of the Party if they are free from the control of the Party. The attitude of the Party towards entrepreneurs and their private enterprises seems to be contradictory. As Haggard and Huang argue, "despite the well-documented process of economic reform in China, the domestic private sector remains relatively small and subject to a variety of policy and economic constraints."[239] Nee and Opper report that

> during the first decade of reform, though the central government encouraged household businesses (geti hu), it explicitly sought to restrict private commercial activities to a peripheral role . . . . Through the decade of the 1990s, the central government's policy sought to contain the private enterprise economy as a peripheral, subordinate sector of the Chinese economy . . . . Although in 2004 the government amended the constitution to confer to private firms equality with state-owned enterprises and formally guaranteed to 'protect the lawful rights and interests of the private sector,' private property remained vulnerable.[240]

In general, "the political logic of reform in China was aimed at safeguarding and protecting the public ownership economy."[241] Entrepreneurs "were more like valued foster-children than part of the family."[242] A plausible explanation for this phenomenon is that the Party might reason that entrepreneurs endowed with economic power and wealth today will gain political power in the future and therefore pose a threat to the supremacy of the Party.[243]

Conversely, when Leninist parties such as the Communist Party of China abandon class struggle for the sake of economic modernization, they typically switch from an exclusionary to an

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239 Stephan Haggard & Yasheng Huang, *The Political Economy of Private-Sector Development in China*, *in* CHINA'S GREAT ECONOMIC TRANSFORMATION 338 (Loren Brandt & Thomas G. Rawski eds., 2008).

240 NEE & OPPER, *supra* note 198, at 5–7.

241 *Id.* at 8.

242 RICHARD MCGREGOR, THE PARTY: THE SECRET WORLD OF CHINA'S COMMUNIST RULERS 228 (2010).

243 YASHENG HUANG, SELLING CHINA: FOREIGN DIRECT INVESTMENT DURING THE REFORM ERA 349 (2003).

inclusionary, or co-optive strategy.[244] In the post-Mao period, intelligentsia, technocrats, and particularly private entrepreneurs are brought into the party-state system because they have the skills and resources desired by the Party to accomplish its new policy agenda (economic growth, technological improvement, etc.); in addition, it is safer for the Party to place these newly emerging classes under its direct oversight rather than leaving them to grow into certain independent powers and finally become a threat to the dominance of the Party.[245] Chen and Naughton conclude that inclusiveness is one of the pillars of the Party's claim to legitimacy.[246] More specifically, they argue that

> when a new social group emerges, the Party begins a political process to incorporate that group into its governance structure. 'Inclusiveness' means that the Party has an obligation to listen to and respond to the interests of new social groups and also that it seeks to ensure that no social group can have an independent power base to challenge the regime from the 'outside.'[247]

Private entrepreneurs can be incorporated into the party-state system through several channels. The first is to recruit private entrepreneurs into the Party who then become so-called "red capitalists."[248] In the late 1990s, approximately 20% of entrepreneurs were Party members, and by 2004, that number had grown to almost 35%.[249] This ratio has been shown to have remained between 30% and 35% over the period between 2002 and 2012.[250] It is worth noting that certain (or even most) private entrepreneurs with Party membership actually joined the Party before they started their business; they used to be affiliated with the party-state in one way or another, such as being an official or a

244 Bruce J. Dickson, *Cooptation and Corporatism in China: The Logic of Party Adaptation*, 115 POL. SCI. Q. 517, 519 (2001).

245 *See id.* at 524.

246 Ling Chen & Barry Naughton, *A Dynamic China Model: The Co-Evolution of Economics and Politics in China*, 26 J. CONTEMP. CHINA 18, 20 (2017).

247 *Id.* at 21.

248 Bruce J. Dickson, *Integrating Wealth and Power in China: The Communist Party's Embrace of the Private Sector,* 192 CHINA Q. 827, 827–28 (2007).

249 *Id.* at 837.

250 Xuan He & Jun Ma, *zhizhengdang dui siying qiye de tonghe celve jiqi xiaoying fenxi (An Analysis on the CCP's Co-opting Strategy towards Private Enterprises and Its Effects)*, 36(5) SHEHUI (SOCIETY) 179 (2016).

manager in an SOE.[251] These veteran Party members seem to be more favored politically than their neophyte counterparts. For example, Lu reports that veteran Party members are more easily selected as delegates of the People's Congress at different levels.[252] It is also worth noting that those private entrepreneurs who are not Party members can still reach the party-state through their relatives, friends, classmates, etc., who are themselves Party members and/or officials.[253] In addition to recruiting private entrepreneurs, the Party also extends its tentacles to the grass-root level of private enterprises by recruiting technicians and ordinary workers and establishing Party branches in private enterprises.[254] By 2009, there were 3.58 million Party members in private enterprises, with ordinary workers accounting for 46% and management staff and technicians accounting for 54%.[255]

The second channel is to elect private entrepreneurs to the People's Congress ("PC") and the People's Political Consultative Conference ("PPCC") at different levels.[256] By 2004, nationwide, over 9,000 entrepreneurs had been elected to the PC and 30,000 to the PPCC at the county level and above.[257] 52% of private entrepreneurs participate in China's political process by acting as delegates of the PC, the PPCC, or the Party's congresses.[258] 37.47%

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251 Peng Lu, *siying qiyezhu ren renda daibiao huo zhengxie weiyuan de yinsu fenxi (An Empirical Analysis on the Impact Factors of Being Representatives in the People's Congress and People's Political Consultative Conference for Private Entrepreneurs)*, 4 SHEHUIXUE YANJIU (SOCIOLOGICAL STUD.) 168–72 (2013); *see generally* Xiangpeng Jin, *chushi zhengzhi ziben, renli ziben, yu siying qiyejia canzhengyizheng (Initial Political Capital, Human Capital, and Private Entrepreneurs' Participation in Politics)*, 55(254) ZHONGSHANDAXUE XUEBAO (JOURNAL OF SUN YAT-SEN UNIVERSITY) 152–61 (2015) (reporting a correlation between the previous affiliation with the party-state and possibility of becoming an entrepreneur).

252 Lu, *supra* note 251.

253 Christopher A. McNally & Teresa Wright, *Sources of Social Support for China's Current Political Order: The 'Thick Embeddedness' of Private Capital Holders*, 43 COMMUNIST & POST-COMMUNIST STUD. 189, 194–95 (2010).

254 Yingshuai Sun, *zhongguo gongchandang dangyuan shuliang yu jiegou bianhua ji fazhan qushi (The Change in Quantity and Structure of CCP Members and Their Trend)*, 5 BEIJING XINGZHENGXUEYUAN XUEBAO (JOURNAL OF BEIJING ADMINISTRATIVE COLLEGE) 31 (2009).

255 *Id.*

256 *See* Dickson, *supra* note 248, at 843.

257 *Id.*

258 Jin, *supra* note 251.

of private entrepreneurs are either PC delegates or PPCC delegates (with an additional 16.68% who are Party members but not delegates of the PC or the PPCC).[259]

Finally, private entrepreneurs may join government-sponsored associations, such as the Private Enterprises' Association and the All-China Industrial and Commercial Federation. A 2002-2004 study of rural private entrepreneurs reports that more than 70% were members of at least one government-sponsored association.[260]

Co-opted entrepreneurs are rewarded for their loyalty to and cooperation with the party-state with certain economic benefits,[261] such as valuable financial resources. Numerous empirical studies confirm that political connections, particularly membership in the People's Congress, help private entrepreneurs to access bank credit more easily and at a better price.[262] Bai, Lu, and Tao find that

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259 Lvjun Zhou, *fuhao fenceng: siying qiyezhu de zhengzhi qianru moshi jiqi diwei rentong chayi (Symbolic Stratification: The Pattern of Private Entrepreneurs' Political Embeddedness and the Difference of Their Status Identification)*, 3 SHEHUI FAZHAN YANJIU (CHINESE JOURNAL OF SOCIAL DEVELOPMENT 35 (2016)).

260 McNally & Wright, *supra* note 253, at 192.

261 Political connections may not only bring material benefits to private entrepreneurs but may also protect private entrepreneurs from public enforcement of certain laws and regulations. *See, e.g.*, Henk Berkman, Rebel A. Cole & Lawrence J. Fu, *Political Connections and Minority-Shareholder Protection: Evidence from Securities-Market Regulation in China*, 45 J. FIN. & QUANTITATIVE ANALYSIS 1391, 1414 (2010) (explaining securities market regulation); *see also* Xin Sun, *Selective Enforcement of Land Regulations: Why Large-Scale Violators Succeed?*, 74 CHINA J. 66, 66 (2015) (arguing land regulation treats violators differently based on their political ties). Private entrepreneurs may enjoy tax benefits as a result of their political connections. Wenfeng Wu et al., *Political Connections, Tax Benefits and Firm Performance: Evidence from China*, 31 J. ACCT. & PUB. POL'Y 277, 277–78 (2012). Political connections could also undermine the role of trade unions in increasing wages. Yang Song, Jidong Yang & Qijing Yang, *Do Firms' Political Connections Depress the Union Wage Effect? Evidence from China*, 38 CHINA ECON. REV. 183, 185–86 (2016). Private entrepreneurs having political connections could also resort to courts more frequently in dispute resolution. *See* Yuen Yuen Ang & Nan Jia, *Perverse Complementarity: Political Connections and the Use of Courts Among Private Firms in China*, 76 J. POL. 318 (2014) (finding political connection firms employ litigation more often than others). In summary, it is concluded that "for private entrepreneurs, close ties to the party-state, such as strong personal guanxi or kinship ties with power-brokers in the Party or membership in the Party and/or one of its affiliated organizations, facilitate their ability to gain information, access credit, procure licenses, avoid onerous taxes, and obtain land." McNally & Wright, *supra* note 253, at 196.

262 Studies that use different proxies for political connections confirm the importance of political connections in helping private entrepreneurs address financial constraints. For Party membership of entrepreneurs, see Hongbin Li et al., *Political Connections,*

"access to bank loans is significantly easier for entrepreneurs who are members of the Chinese People's Congress, but membership of the Chinese People's Political Consultative Conference has a limited effect."[263] This conclusion is further supported by many subsequent studies.[264] In addition to bank loan accessibility, political connections are also shown to matter for private enterprises' access to China's stock markets.[265] Firms with political connections reap other preferential benefits in the process of going public, such as a relatively higher offering price, lower underpricing, and lower fixed costs during the going-public process.[266]

With the help of FDP, through which the party-state can influence the direction of financial resources, the Party's co-optation strategy seems to work considerably well, as co-opted entrepreneurs show strong support toward the status quo in which the Party enjoys monopolized political power.[267] Private

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Financing and Firm Performance: Evidence from Chinese Private Firms, 87 J. DEV. ECON. 283, 296 (2008); Di Guo et al., *Political Economy of Private Firms in China*, 42 J. COMP. ECON. 286, 300–01 (2014). For government intervention in CEO appointment, see Robert Cull et al., *Government Connections and Financial Constraints: Evidence from a Large Representative Sample of Chinese Firms*, 32 J. CORP. FIN. 271, 272 (2015). For top managers (or board members) as officials at certain levels, see Zhong-Qin Su & Hung-Gay Fung, *Political Connections and Firm Performance in Chinese Companies*, 18 PAC. ECON. REV. 283, 285–86 (2013).

263 Chong-En Bai, Jiangyong Lu & Zhigang Tao, *Property Rights Protection and Access to Bank Loans: Evidence from Private Enterprises in China*, 14 ECON. TRANSITION 611, 623–24 (2006).

264 *See, e.g.*, Wubiao Zhou, *Bank Financing in China's Private Sector: The Payoffs of Political Capital*, 37 WORLD DEV. 787, 797 (2009); Xin Sun, Jiangnan Zhu & Yiping Wu, *Organizational Clientelism: An Analysis of Private Entrepreneurs in Chinese Local Legislature*, 14 J. EAST ASIAN STUD. 1, 13–14 (2014); Deming Yang, Zhengfei Lu & Danglun Luo, *Political Connections, Media Monitoring and Long-term Loans*, 7 CHINA J. ACCT. RES. 165, 167 (2014); Xunan Feng, Anders C. Johansson & Tianyu Zhang, *Mixing Business with Politics: Political Participation by Entrepreneurs in China*, 59 J. BANKING & FIN. 220, 223 (2015); Hongxin Zhao & Jiangyong Lu, *Contingent Value of Political Capital in Bank Loan Acquisition: Evidence from Founder-controlled Private Enterprises in China*, 31 J. BUS. VENTURING 153, 170 (2016).

265 *See, e.g.*, Qigui Liu, Jinghua Tang & Gary Gang Tian, *Does Political Capital Create Value in the IPO Market? Evidence from China*, 23 J. CORP. FIN. 395, 398 (2013); *see also* Guoping Li & Hong Zhou, *Political Connections and Access to IPO Markets in China*, 33 CHINA ECON. REV. 76, 77 (2015).

266 Bill B. Francis, Iftekhar Hasan & Xian Sun, *Political Connections and the Process of Going Public: Evidence from China*, 28 J. INT'L MONEY & FIN. 696, 696 (2009).

267 *See* Jie Chen & Bruce J. Dickson, *Allies of the State: Democratic Support and*

entrepreneurs with Party membership (and those who have applied to join the Party, those who were formerly cadres, and those who were formerly SOE managers) have significantly higher levels of regime support than entrepreneurs who have no political affiliations with the party-state.[268] Private entrepreneurs, particularly co-opted entrepreneurs, apparently also share similar viewpoints on a range of political, economic, and social issues with communist officials.[269] Dickson then concludes that "China's private entrepreneurs and red capitalists in particular are not only increasingly integrated into the political system, they have views that are increasingly similar to those of local Party and government officials, making them unlikely agents of political change."[270] Private entrepreneurs with Party membership also have shown a much higher evaluation of the Party's policies than entrepreneurs without such status.[271]

B. *The Role of Interest Groups*

Interest groups play an increasingly important role in China's political arena, despite the Party's dubious attitude towards and tight control over these groups.[272] Li describes the current government-society relationship in China as "weak government, strong interest groups" and argues that "never in the six-decade history of the PRC have interest groups been as powerful and influential as they have been in recent years."[273] Similarly, Lampton concludes that "on issues both foreign and domestic, interest groups have become increasingly vocal participants in the policy process," and "China's bureaucracy has adapted to the proliferation of interests by becoming more pluralized itself."[274]

Regime Support among China's Private Entrepreneurs, 196 CHINA Q. 780, 787 (2008).

268 *Id.* at 802.

269 *Id.* at 790–91.

270 Dickson, *supra* note 248, at 847.

271 He & Ma, *supra* note 250.

272 *See, e.g.*, Tony Saich, *Negotiating the State: The Development of Social Organizations in China*, 161 CHINA Q. 124, 126 (2000) (arguing that "while there is an increasing acceptance of the social organization sector and its further development, senior CCP leaders have made it clear that this is no free-for-all for society to organize itself to articulate its interests. Rather they prefer that the sector be developed within a highly restrictive legislative and organizational framework that ensures CCP and state control").

273 Cheng Li, *The End of the CCP's Resilient Authoritarianism? A Tripartite Assessment of Shifting Power in China*, 211 CHINA Q. 595, 613 (2012).

274 David M. Lampton, *How China Is Ruled: Why It's Getting Harder for Beijing to*

1. *SOEs and Local Governments*

The most salient interest group that may influence China's policy process consist of enterprises, particularly large SOEs. Industry associations and chambers of commerce also matter for policy outcomes to a certain extent.[275] For example, Downs' study on the relationship between China's national oil companies and the party-state leads her to conclude that "the projects pursued by the energy state-owned enterprises tend to shape the country's energy policies rather than vice versa."[276] Similarly, Cai reports a case that China's National Electricity Corporation achieved a monopoly by manipulating a grid remodeling project implemented by the Chinese government to provide electricity to most peasants in the country.[277] There is also evidence that leading wind turbine and solar panel manufacturers or state-owned electricity utility companies have shaped China's renewable energy policy process.[278] In general, Deng and Kennedy conclude that "all types of companies-state-owned and private, Chinese and foreign-have become active in every stage of the policy process, from setting the agenda to identifying policy options and shaping regulatory implementation."[279] As a result: "policies for different sectors and the broader economy have been shaped by corporate influence."[280] They further report that "the Chinese government does not want to be seen as being subject to lobbying, since it may imply a vulnerability to pressure, the adoption of policy based on particularistic interests, or even impropriety."[281] Powerful interest groups, such as large firms, therefore attempt to keep a low profile

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Govern, 93 FOREIGN AFF. 74, 80 (2014).

275 *See* Guosheng Deng & Scott Kennedy, *Big Business and Industry Association Lobbying in China: The Paradox of Contrasting Styles*, 63 CHINA J. 101, 105–07 (2010); Jianxing Yu, Kenichiro Yashima & Yongdong Shen, *Autonomy or Privilege? Lobbying Intensity of Local Business Associations in China*, 19 J. CHINESE POL. SCI. 315, 318 (2014).

276 Erica S. Downs, *Business Interest Groups in Chinese Politics: The Case of the Oil Companies*, *in* CHINA'S CHANGING POLITICAL LANDSCAPE: PROSPECTS FOR DEMOCRACY 121, 137 (Cheng Li ed., 2008).

277 Yongshun Cai, *Managing Group Interests in China*, 129 POL. SCI. Q. 107, 118 (2014).

278 Wei Shen, *Who Drives China's Renewable Energy Policies? Understanding the Role of Industrial Corporations*, 21 ENVTL. DEV. 87, 96 (2017).

279 Deng & Kennedy, *supra* note 275, at 101.

280 *Id.* at 102.

281 *Id.* at 122.

(under-reporting their political influence) when asked to estimate their influences on policy outcomes.[282]

Local governments are another powerful interest group. As noted by Li, "local governments in the coastal and inland regions are political interest groups that exert strong influence in Beijing and work to ensure that the central government adopts socio-economic policies that advance their regional interests."[283] Economic policies issued by the central government are frequently thwarted by local officials if these policies are in conflict with their own policy priorities and objectives. For instance, when the central government attempted to moderate excessive investment in residential real estate by instructing local governments to limit the increase in land prices, local leaders, particularly at the municipal level, ignored or undermined these mandates because they were heavily dependent on revenues gained from the leasing and sale of land to finance local programs.[284] Wang also finds that when the Chinese central government attempted to address accelerated investment growth by implementing an economic austerity policy in 2004, eight provinces intentionally resisted it by delaying its enforcement or altering the policy to fit their interests.[285]

Both enterprises and local governments have a strong incentive to lobby for a distorted financial environment. For enterprises, financial distortions such as artificially lower interest rates may contribute to their earning capability by lowering the cost of capital. Indeed, enterprises—particularly SOEs—benefit greatly from China's interest rate controls. Ma and Yi find that net interest payments as a share of GDP by the non-financial corporate sector dropped by 50% between 1992 and 2007.[286] As a result of the financial distortions, Chinese enterprises receive an implicit subsidy in the form of artificially low costs of capital.[287] The low cost of financing has led to a significant increase in the profitability of

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282 *See id.*

283 Li, *supra* note 273, at 613.

284 NICHOLAS LARDY, SUSTAINING CHINA'S ECONOMIC GROWTH AFTER THE GLOBAL FINANCIAL CRISIS (2012).

285 *See* Chia-Chou Wang, *Pioneering, Bandwagoning and Resisting: The Preferences and Actions of Chinese Provinces in the Implementation of Macroeconomic Regulation and Control Policies*, 24 J. CONTEMP. CHINA 315, 331 (2015).

286 *See* Guonan Ma & Wang Yi, *China's High Saving Rate: Myth and Reality*, 122 INT'L ECON. 5, 20 (2010).

287 *See also* Huang, *supra* note 18; Huang & Tao, *supra* note 18.

enterprises since the early 1990s.[288] The ratio of profits to "industrial value added rose from an average of 22.6% over the 1995–1999 period to 34.4% in 2008; the share of enterprise income in GDP rose from 14.2% in the second half of the 1990s to 22.9% in 2008."[289]

Local governments may also prefer certain inefficient financial policies, such as lower interest rates and devalued currency, both of which can be relied on to boost local economic growth. Economic growth is important because economic goals, such as GDP growth, tax collection, and Foreign Direct Investment ("FDI") inflow have long been used by the party-state as performance targets that are tightly correlated with the prospects for promotion of local officials and that therefore incentivizes them to pursue economic growth at any cost.[290] For example, Li and Zhou show that the likelihood of a provincial leader being promoted increases with better economic performance (measured by GDP growth), whereas the likelihood of termination decreases their economic performance.[291] However, other scholars find no evidence that strong growth performance was rewarded with higher bureaucratic ranks.[292] Instead, these authors find that factional ties with top leaders, educational qualification, and provincial revenue collection play substantial roles in cadre promotions.[293] A more balanced conclusion is reached by Jia, Kudamatsu, and Seim, who find that "connections and performance are complements in the Chinese political selection process."[294]

Local governments may also prefer credit discrimination which can be used by local officials to distribute patronage. Enterprises and local governments may even collude with each other and

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288 *See* Dennis Tao Yang, *Aggregate Savings and External Imbalances in China*, 26 J. ECON. PERSP. 125, 133–34 (2012).

289 *Id.* at 134.

290 *See, e.g.*, Hongbin Li & Li-An Zhou, *Political Turnover and Economic Performance: The Incentive Role of Personnel Control in China*, 89 J. PUB. ECON. 1743 (2005).

291 *Id.*

292 Victor Shih, Christopher Adolph & Mingxing Liu, *Getting Ahead in the Communist Party: Explaining the Advancement of Central Committee Members in China*, 106. POL. SCI. REV. 166, 166 (2012).

293 *Id.*

294 Ruixue Jia, Masayuki Kudamatsu & David Seim, *Political Selection in China: The Complementary Roles of Connections and Performance*, 13 J. EUR. ECON. ASS'N 631, 634 (2015).

pressure the central government to adopt certain distortionary policies, such as an undervalued exchange rate that benefits both exporting enterprises and coastal provinces where these enterprises are located.[295] Kaplan concludes that Chinese policymakers are reluctant to pursue greater exchange rate flexibility because "the manufacturing sector's strong performance has boosted the wealth and influence of coastal regional governments, spurring them to advocate for an extension of preferential exchange rate policies to their regions from the central government."[296] Similarly, Steinberg and Shih argue that China keeps its exchange rate undervalued because the interest groups that support undervaluation (a coalition consisting of tradable industries, coastal provincial governments, and certain governmental agencies, such as the Ministry of Commerce and the most powerful National Development and Reform Commission) are more powerful than those that oppose undervaluation (such as China's central bank, the People's Bank of China, which represents the interests of the banking sector).[297]

2. *Factions within the CCP*

Financial policies are not only influenced by interest groups that are outside the party-state system (such as exporting enterprises) or that are at the low or intermediate level of the political hierarchy (such as local governments).[298] Financial policies are also shaped by the preferences of certain interest groups at the highest level of the party-state. More precisely, financial policies are determined by struggles between factions inside the Party. As a Leninist organization, the Party is supposed to maintain an extremely high level of solidarity and unity with the help of severe discipline, clear hierarchical structure, and more importantly, the so-called principle of "democratic centralism."[299] The core of "democratic centralism," as defined by the Party's Constitution, is

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295 *See, e.g.*, Stephen B. Kaplan, *The Political Obstacles to Greater Exchange Rate Flexibility in China*, 34 WORLD DEV. 1182, 1193 (2006); David A. Steinberg & Victor C. Shih, *Interest Group Influence in Authoritarian States: The Political Determinants of Chinese Exchange Rate Policy*, 45 COMP. POL. STUD. 1405, 1421 (2012).

296 *See* Kaplan, *supra* note 295, at 1196.

297 Steinberg & Shih, *supra* note 295, at 1407.

298 *See, e.g.*, Susan Lawrence & Michael Martin, *Understanding China's Political System*, CONG. RES. SERV., 35 (2013).

299 *See* Constitution of the Communist Party of China, Nov. 14, 2002, art. 3.

> individual Party members are subordinate to the Party organization, the minority is subordinate to the majority, the lower Party organizations are subordinate to the higher Party organizations, and all the constituent organizations and members of the Party are subordinate to the National Congress and the Central Committee of the Party.[300]

However, this is far from reality. As numerous studies have shown, intra-elite struggles and factional politics are important in understanding the history of the Party.[301]

Factional politics reached a new level after 1978, when China began to gradually move away from rule by a single leader (such as Chairman Mao) and toward a collective form of leadership.[302] Recent leaders such as Jiang Zemin and Hu Jintao were to a large extent merely "first among equals" in their respective generations of collective leadership and could hardly wield the sort of power enjoyed by Mao (or Deng Xiaoping). Rather, newer leaders have had to govern the Party through coalition-building and political compromise; as a result, factional politics prevails in the political arena. However, since he became the general secretary of the Party in 2012, Xi Jinping has changed the political status quo to a certain extent with his bold anti-corruption campaign and his aggressive

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300 *Id.* art. 10 § 1.

301 *See* Andrew Nathan, *A Factionalism Model for CCP Politics*, 53 CHINA QUARTERLY 34, 50 (1973); Tang Tsou, *Prolegomenon to the Study of Informal Groups in CCP Politics*, 65 CHINA Q. 98, 110 (1976) (the seminal works on this issue). For more recent studies, see JING HUANG, FACTIONALISM IN CHINESE COMMUNIST POLITICS (2000); JOSEPH FEWSMITH, ELITE POLITICS IN CONTEMPORARY CHINA (2001); ZHIYUE BO, CHINA' ELITE POLITICS: POLITICAL TRANSITION AND POWER BALANCING (2007); VICTOR SHIH, FACTIONS AND FINANCE IN CHINA: ELITE CONFLICT AND INFLATION (2008); see also Andrew Nathan & Kellee S. Tsai, *Factionalism: A New Institutional Restatement*, 34 CHINA J. 157, 157 (1995) ("For twenty-two years scholars have found the factionalism model useful as a starting point for analyzing how Chinese elite politics work."); Lowell Dittmer, *Chinese Informal Politics*, 34 CHINA J. 1, 5 (1995) (argues that factionalism "constitutes a central, even modal, pattern of Chinese political behavior deeply rooted in cultural and psychological security drives"); Victor Shih, Wei Shan & Mingxing Liu, *Gauging the Elite Political Equilibrium in the CCP: A Quantitative Approach Using Biographical Data*, 201 CHINA Q. 79 (2010) (tracking the biographies of all Central Committee members of the Party from 1921 to 2007 and showing that even Chairman Mao Zedong, the charismatic and all-powerful leader, could not maintain a commanding presence in the Party elite after the establishment of the People's Republic).

302 According to the 2007 Party Congress Communiqué, "collective leadership" is "a system with division of responsibilities among individual leaders in an effort to prevent arbitrary decision making by a single top leader." Li, *supra* note 273, at 609.

consolidation of power.[303] It remains to be seen whether the form of collective leadership can be maintained in the future.[304]

Factional politics influence the design and implementation of economic policies, including financial policies. As Cai and Treisman argued, "faction leaders sought supremacy within the Party by demonstrating the effectiveness of their chosen policies across the chessboard of China's territorial administration,"[305] and we therefore can witness "the temporal pattern of reform, which ebbed and flowed with shifts in the factional balance of power."[306] Similarly, Ho concludes that "particular reform policies, anticorruption measures, and even corporate decisions in specific markets are increasingly used as political weapons in high-level political struggles."[307]

The path of Chinese financial reform in the mid-1990s was shaped by a series of short-term political calculations aimed at strengthening the power of individual leaders, or more specifically, the former Premier Zhu Rongji (and his faction).[308] Zhu's faction (and factions with similar preference, i.e., central control over policy tools, including financial resources) has been defined as the "technocratic faction" (they are mainly central bureaucrats who have ranks of vice minister or above).[309] Another faction, which is termed the "generalist faction"[310] consists of provincial leaders who have the strongest control over the Party apparatus and who prefer to decentralize financial power so that their followers at local levels may access bank loans to boost local economic development. Such

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303 *See, e.g.*, U.S.-China Economic and Security Review Commission, *The Consolidation of Political Power in China Under Xi Jinping: Implications for the PLA and Domestic Security Forces*, Feb. 16, 2019 (testimony by Timothy R. Heath).

304 For more detailed discussions on this issue, see CHENG LI, CHINESE POLITICS IN THE XI JINPING ERA: REASSESSING COLLECTIVE LEADERSHIP (2016); *see also* SEBASTIAN HEILMANN & MATTHIAS STEPAN, CHINA'S CORE EXECUTIVE: LEADERSHIP STYLES, STRUCTURES AND PROCESS UNDER XI JINPING (2016).

305 Hongbin Cai & Daniel Treisman, *Did Government Decentralization Cause China's Economic Miracle?*, 58 WORLD POL. 505, 507 (2006).

306 *Id.*

307 Wing-Chung Ho, *What Analyses of Factional Politics of China Might Miss When the Markets Becomes a Political Battlefield: The Telecommunication Sector as a Case in Point*, 13 CHINA REV. 71, 85 (2013).

308 Victor Shih, *Dealing with Non-Performing Loans: Political Constraints and Financial Policies in China*, 180 CHINA Q. 922, 922 (2004).

309 SHIH, supra note 301.

310 *Id.*

factional ties have had a significant positive effect on the distribution of bank loans to provinces during the reform era.[311]

The core of Zhu's reform strategy was to centralize power in financial resource allocation. By consolidating financial power to the central level (and depriving local officials of access to cheap credit from banks), Zhu could use the distribution of financial resources as a political bargaining chip at the Politburo level. With control over financial resources, he could bargain either for political support in the event of a setback, or for the promotion of a close protégé, which would increase his post-retirement influence.[312] In addition, Zhu and his followers had a strong disincentive to carry out fundamental financial reforms (eradicating financial distortions) that could have benefited China's economy in the long-term but could have potentially jeopardized short-term stability; after all, their performance was evaluated by short-term results.[313] The real consequence of the so-called "financial reform" in the Zhu era was therefore a consolidation of financial power and covering up the fundamental problems (such as the Non-Performing Loans problem) rather than conducting a market-oriented financial overhaul.

It became even more infeasible to conduct serious financial reform in the Hu-Wen era (2002-2012), thanks to the factional conflict. Policy making and implementation became considerably more difficult in the era, particularly when there was disagreement or controversy among factions.[314] It has been argued that since Hu Jintao and Wen Jiabao took power, market-oriented liberalization had been "minor."[315] Therefore, the United States should be wary

311 Victor Shih, *Factions Matter: Personal Networks and the Distribution of Bank Loans in China*, 13 J. CONTEMP. CHINA 3, 12 (2006).

312 His disciples, such as Lou Jiwei and Guo Shuqing, still play important roles in China's economic decision-making. Lou was China's Minister of Finance between 2013 and 2016 and is now the Chairman of the National Council of Social Security Fund. Guo was the Governor of the Shandong Province between 2013 and 2017 and is now the Chairman of the China Banking Regulatory Commission ("CBRC") and deputy governor (as well as the Communist Party chief) of China's central bank ("PBOC"). For the relationship between Zhu and Lou and Guo, see David M. Finkelstein, Maryanne Kivlehan *China's Leadership in the Twenty-First Century: The Rise of the Fourth Generation in* ROUTLEDGE HANDBOOK OF THE CHINESE COMMUNIST PARTY, WILLY WO-LAP LAM (2018).

313 Victor Shih, *Partial Reform Equilibrium, Chinese Style: Political Incentives and Reform Stagnation in Chinese Financial Policies*, 40 COMP. POL. STUD. 1238, 1247 (2007).

314 Li, *supra* note 273, at 609.

315 Derek Scissors, *Deng Undone: The Costs of Halting Market Reform in China*, 88

of "fake Chinese economic reform."[316] Factional politics seems to have continued to dampen the outlook of China's financial liberalization in the Xi-Li era since 2012.[317] Whereas it has been argued that market-oriented reform has found new momentum after the Third Plenum of the 18th Party Congress,[318] which was held in November 2013, a recent estimation of the reform performance of the new generation of leaders concludes that "it is impossible to resist the conclusion that the reform process overall has stumbled and is in serious trouble."[319] A plausible explanation lies in the fact that there are two camps inside the decision-making circle, which disagree on certain fundamental economic issues such as the priority of economic growth (speed versus efficiency), the risk of accumulating debt, and the model of SOE reform.[320] The conflict between these two groups became public after the publication of an article on May 9, 2016 in People's Daily. Because the author of this article is believed to be the right-hand man of President Xi, and this

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FOREIGN AFF. 24, 24 (2009).

316 Derek Scissors, *The US Should be Wary of Fake Chinese Economic Reform*, ISSUE BRIEF 4014, 1 (2013).

317 This refers to the period where Xi Jinping became general secretary of the Party in 2012 and Li Keqiang became premier.

318 According to the decision ("Decision on Major Issues Concerning Comprehensively Deepening Reforms") reached by this conference, for the first time, market forces are acknowledged to play a "decisive" role in resource allocation rather than the "basic" role admitted by previous Party decisions. The to-do list laid out by the decision is extraordinarily ambitious, comprised of sixty articles, and because each article contains several specific policy initiatives, over 300 different policy initiatives. Basically, every important economic issue is addressed by the decision, including the liberalization of interest and exchange rates, the assignment of expenditure responsibilities between the central and local governments, and the dividend policy of state-owned enterprises. Decision on Major Issues Concerning Comprehensively Deepening Reforms (Adopted at the Third Plenary Session of the 18th Central Comm. of the Communist Party of China, Nov. 12, 2013). This decision is available in Chinese at: http://news.xinhuanet.com/politics/2013-11/15/c_118164235.htm [https://perma.cc/7FSE-ZQSP]. An abridged version of the decision in English is available at: http://english.court.gov.cn/2015-10/08/content_22130532.htm [https://perma.cc/H5Q6-WLLD].

319 Barry Naughton, *Xi Jinping's Economic Policy in the Run-up to the 19th Party Congress: The Gift from Donald Trump*, 52 CHINA LEADERSHIP MONITOR 1, 3 (2017).

320 *See* Barry Naughton, *Two Trains Running: Supply-Side Reform, SOE Reform and the Authoritative Personage*, 50 CHINA LEADERSHIP MONITOR 1, 6 (2016); Barry Naughton, *Supply-Side Structural Reform: Policy-makers Look For a Way Out*, 49 CHINA LEADERSHIP MONITOR 1, 5 (2016).

article openly criticized Premier Li Keqiang's policies,[321] this event is described as "a severe policy split in the leadership between Xi Jinping, who favors pressing forward with reform now despite the sagging growth rate of China's economy, and Premier Li Keqiang, who is perceived to be pressing for short-term stimulus measures to sustain higher growth rates and postponing reform."[322] The aftermath of this factional conflict on China's financial landscape remains to be seen.

3. *Demand and Supply*

As this story of China shows, although China obviously has very peculiar features, it also constitutes an interesting confirmation of the thesis developed in sections II and III that financially distorting regulation is the result of supply and demand for that particular type of regulation. Indeed, both demand and supply factors influence the design and implementation of FDP in China. Whereas the party-state monopolizes the policy-making process, it is undeniable that certain interest groups, such as large enterprises, local governments, government agencies, and certain factions inside the Party, also matter for understanding the evolution path of China's financial policies. Actually, the difference between the demand side and the supply side may be even blurred in the reality. For example, Premier Zhu and his faction both demand FDP so that their power base can be consolidated, but they also supply FDP as the main decision-maker in the rule making process. Both local governments and large enterprises[323] are part of the party-state system. It may

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321 President Xi and Premier Li are believed to be affiliated with different factions.

322 Alice Miller, *'Core' Leaders, 'Authoritative Persons', and Reform Pushback*, 50 CHINA LEADERSHIP MONITOR 1, 9 (2016).

323 *See* Wang, *supra* note 217. All SOEs, big or small, are controlled by the party-state through the following four mechanisms: (1) all or most of the top executives and many other employees at SOEs are Party members, and the fundamental discipline of the Party requires all Party members to comply with the Party line; (2) the Party decides the appointment and promotion of the top executives of SOEs; (3) Party cells within the SOEs convene meetings to make important decisions for the company and to ensure that the operation of the company is consistent with the Party line; and (4) SOE executives accused of wrongdoing are investigated by the Party and punished under Party discipline. For more detailed discussions on the control of the Party, *see* MCGREGOR, *supra* note 242 (2010); Katharina Pistor, *The Governance of China's Finance*, *in* CAPITALIZING CHINA 30–65 (Joseph Fan & Randall Morck eds., 2012); Lin & Milhaupt, *supra* note 215. Even private enterprises, particularly large private enterprises, are highly influenced or even experience direct intervention by the party-state. *See, e.g.*, Curtis J. Milhaupt & Wentong Zheng,

therefore be reasonable to argue that supply side and demand side mutually influence and reinforce each other, jointly contributing to distorted financial regulation in China.

VI. Conclusion

We built a simple demand-supply framework to investigate the political determinants of FDP across the world in this study. On the demand side, interest groups play an important role in shaping financial policies that may benefit these groups at the cost of economic efficiency and social welfare in many countries, including non-democratic countries but particularly democratic countries. On the supply side, governments, particularly governments in non-democratic regimes, embrace FDP enthusiastically because economic rents created by FDP can be relied on to buy support from certain constituents without which the rule of these regimes may be imperiled. With the help of this framework, financial policies in certain countries, such as China, where a highly distorted financial environment has been maintained for decades, can be better understood.

The analysis presented in this study implies that it is difficult to reform (not to mention eradicate) FDP, despite their efficiency losses. Indeed, inefficient economic policies will not be changed just because they are inefficient.[324] Any effort that attempts to reform inefficient policies, such as FDP, will face formidable challenges from their beneficiaries, such as enterprises that may have access to cheap credit, banks that enjoy monopoly status, or politicians who may exchange financial resources with political loyalty. Unless the victims of FDP are politically more powerful and better organized than the beneficiaries of FDP, which is usually highly unlikely, the disease of FDP can hardly be cured.

Beyond Ownership: State Capitalism and the Chinese Firm, 103 GEO. L. J. 665, 667 (2015).

324 Daron Acemoglu & James Robinson, *Economic Backwardness in Political Perspective*, 100 AM. POL. SCI. REV. 115, 115 (2006) (defining a "political replacement effect," i.e., political elites will block beneficial economic and institutional change when they are afraid that these changes will destabilize the existing system and make it more likely that they will lose political power and future rents); Daron Acemoglu & James A. Robinson, *Economics versus Politics: Pitfalls of Policy Advice*, 27 J. ECON. PERSP. 173, 189–90 (2013) (arguing that inefficient economic policies can be maintained because these policies help to achieve a political equilibrium by creating and distributing economic rents).

Another implication is that democracy is not a panacea. Whereas financial distortions are indeed less severe in democracies, they do not vanish at all, thanks to the efforts of interest groups. As the evidence has shown, even in the United States, where democratic institutions are highly developed, financial policies are consistently bent to serve the interest of certain groups. In other words, for non-democratic regimes, a process of democratization will not be accompanied automatically by a process of financial liberalization and financial development. To accelerate financial development, we need to both tie the "grabbing hands" of politicians and tie the "grabbing hands" of powerful interest groups.